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In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 1037

LIKINS-FOSTER HONOLULU CORP., et al.,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Appendices B, C and D to Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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Appendix B

In the Tax Court of the United States

Nos. 1004-64, 1005-64, 1025-64, 1026-64, 1027-64, 1028-64, 1029-64, 1030-64, 1031-64, 1032-64, 1033-64, 1034-64, 1035-64, 1036-64, 1037-64, 1038-64, 1039-64, 1040-64, 1041-64, 1042-64, 1088-64.

T. Jack Foster, et al.,
Petitioners,

vs.

Commissioner of Internal Revenue,
Respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SCOTT, Judge: Respondent determined deficiencies in the income tax liability of Likins-Foster Honolulu Corporation and subsidiaries for the fiscal years ended June 30, 1957, June 30, 1958, and June 30, 1959, in the respective amounts of $109,603.60, $744,425.31, and $643,982.47, and by amendment to answer claimed an increased deficiency for the fiscal year ended June 30, 1957, making a total deficiency claimed for that year of $161,082.09.[2]

2. Likins-Foster Ord Corporation, Likins-Foster Monterey Corporation, Likins-Foster Biggs Corporation, and Likins-Foster El Paso Corporation each ceased to be a member of the consolidated group as of February 10, 1958, and were therefore not included in the consolidation for the remainder of the fiscal year ended June 30, 1958, or for any portion of the fiscal year ended June 30, 1959. The first year for which Central Development Company, Ltd., was a member of the consolidation was the fiscal year ended June 30, 1958, and it continued to be a member of the consolidation through the fiscal year ended June 30, 1959. All other subsidiaries were members of the consolidation throughout the entire period covered by the fiscal years here in issue.

Respondent determined deficiencies in income tax and addition to the tax under section 6651(a) of the Internal Revenue Code of 1954[3] for the taxable period February 11, 1958, through June 30, 1958, and a deficiency in income tax for the fiscal year ended June 30, 1959, of Likins-Foster Ord Corp., transferor, in the respective amounts of $155,326.33, $38,831.58, and $97,756.63, and further determined that Likins-Foster Honolulu Corporation, T. Jack Foster, T. Jack Foster Jr., John R. Foster, and Richard H. Foster were each liable as a transferee of Likins-Foster Ord Corporation in the amount of $291,914.54. By amendments to answers, respondent claimed an increased deficiency in income tax for the fiscal year ended June 30, 1959, of Likins-Foster Ord Corp., transferor, in the amount of $18,049.87, bringing the total deficiency in income tax of the transferor claimed for this year to $115,806.50 and alleged that Likins-Foster Honolulu Corp., T. Jack Foster, T. Jack Foster, Jr., John R. Foster, and Richard H. Foster were each liable as a transferee of Likins-Foster Ord Corp. in the respective amounts of $309,964.41, $90,058.22, $10,006.47, $10,006.47, and $10,006.47.

Respondent determined deficiencies in income tax and addition to the tax under section 6651(a) for the taxable period February 11, 1958, through June 30, 1958, and a deficiency in income tax for the fiscal year ended June 30, 1959, of Likins-Foster Monterey Corp., transferor, in the respective amounts of $138,052.06, $34,513.02, and $97,756.63, and further determined that Likins-Foster Honolulu Corporation, T. Jack Foster, T. Jack Foster, Jr., John R. Foster, and Richard H. Foster were each liable as a transferee of Likins-Foster Monterey Corporation in the amount of $270,321.71. By amendments to answers respondent alleged that the deficiency in income tax for the fiscal year ended June 30, 1959, of Likins-Foster Monterey Corp., transferor, should be decreased by the amount of $18,049.88, leaving a total deficiency

3. All references are to the Internal Revenue Code of 1954 unless otherwise stated.

in income tax of the transferor claimed for this year of $79,706.75 and alleged that Likins-Foster Honolulu Corp., T. Jack Foster, T. Jack Foster, Jr., John R. Foster and Richard H. Foster were each liable as a transferee of Likins-Foster Monterey Corp. in the respective amounts of $252,271.83, $91,707.59, 10,189.75, $10,189.75 and $10,189.75.

Respondent determined a deficiency in income tax for the fiscal year ended June 30, 1959, of Likins-Foster Biggs Corp., transferor, in the amount of $42,250 and further determined that Likins-Foster Honolulu Corporation, T. Jack Foster, T. Jack Foster, Jr., John R. Foster and Richard H. Foster were each liable as a transferee of Likins-Foster Biggs Corp., in the amount of $42,250. By amendments to answer respondent claimed an increased deficiency in income tax for the fiscal year ended June 30, 1959 of Likins-Foster Biggs Corp., transferor, in the amount of $625 bringing the total deficiency in income tax of the transferor claimed for this year to $42,875 and alleged that Likins-Foster Honolulu Corp., T. Jack Foster, T. Jack Foster, Jr., John R. Foster and Richard H. Foster were each liable as a transferee of Likins-Foster Biggs Corp., in the respective amounts of $42,875, $42,875, $15,057.58, $15,057.59 and $15,057,58.

Respondent determined a deficiency in income tax for the fiscal year ended June 30, 1959, of Likins-Foster El Paso Corp., transferor, in the amount of $42,250 and further determined that Likins-Foster Honolulu Corporation, T. Jack Foster, T. Jack Foster, Jr., John R. Foster and Richard H. Foster were each liable as a transferee of Likins-Foster El Paso Corp., in the amount of $42,250. By amendments to answers respondent claimed a decreased deficiency in income tax for the fiscal year ended June 30, 1959, of Likins-Foster El Paso Corp., transferor, in the amount of $625 bringing the total deficiency in income tax of the transferor claimed for this year to $41,625 and alleged that Likins-Foster Honolulu Corp., T. Jack Foster, T. Jack Foster, Jr., John R. Foster, and Richard H. Foster were each liable as a transferee of

Likins-Foster El Paso Corp. in the respective amounts of $41,625, $41,625, $14,529.38, $14,529.38, and $14,529.38.

Some of the issues raised by the pleadings have been disposed of by the parties, each party having made certain concessions at the trial or on brief. The issues left for our decision are the following:

(1) Whether the net operating loss deduction claimed by Likins-Foster Honolulu Corp. and subsidiaries on their consolidated corporate tax return for the fiscal year ended June 30, 1957, should be reduced by $639,488.61 or any portion thereof. The reduction of $639,488.61 in the claimed net operating loss is composed of several items so that resolution of this issue is dependent upon the decision reached as to the following questions:

(a) Whether the gains upon the sale of 421 houses to persons unrelated to any of the corporations in the Likins-Foster Honolulu Corp. consolidated group were properly reallocated by respondent under the provisions of section 482 from the affiliates reporting the gains to another affiliate which had originally owned the houses but had purportedly made a transfer of the houses to the affiliates reporting the gains. If respondent properly reallocated the gains realized on the sale of these houses, then the separate income for the fiscal year ended June 30, 1957, of each of the affiliates which reported these gains would be reduced by the amounts of such gains reported and certain loss carryovers incurred by the affiliates prior to the time they became members of the consolidated group would not be usable, thereby reducing the total net operating loss available to the consolidated group for the fiscal year ended June 30, 1957, by $388,891.28. If the gains were not properly reallocated, did they constitute ordinary income to the affiliates reporting them?

(b) What is the proper method to be used in the application of net operating loss carryovers of affiliates from years for which those affiliates filed separate returns to years in

which the affiliates were members of the group filing a consolidated return?[4]

(c) Whether the income of Likins-Foster Honolulu Corp. for the taxable year ended June 30, 1956, should be increased by the amount of $153,671 distributed to it in cash from two of its subsidiaries so that the loss carryover to the fiscal year ended June 30, 1957, should properly be decreased by this amount. The correctness of the increase in the income of Likins-Foster Honolulu Corp. requires a determination of whether cash distributions to it by two of its subsdiaries were dividends or were distributions which reduced the parent's basis in the stock of its subsidiaries with the excess received over its basis in the stock constituting taxable income to the parent.

(2) Whether Likins-Foster Honolulu Corp. realized gains during its fiscal year ended June 30, 1957, from payments made to it by two of its subsidiaries for redemption of stock of those two subsidiaries. One of the two subsidiaries was one that had made distributions to the parent corporation in 1956 which respondent had determined to result in taxable income to the parent in that year and therefore the determination of whether the distributions in 1956 reduced the parent's basis in the subsidiaries' stock affects the amount above basis which the parent received upon redemption. The other subsidiary had made a distribution to the parent in 1956 which respondent determined reduced the basis of the parent in its stock although respondent made no determination that income resulted in the fiscal year 1956 from this distribution since the reduction in basis of stock was less than the parent's basis in the stock. The amount of the

4. We will use the term "separate net operating loss carryover" to refer to carryover of affiliates from years for which separate returns were filed and the terms "separate income" or "separate net income" to refer to the income of affiliates computed prior to the combining of the income and losses of all members of the affiliated group for the computation of consolidated net income.

parent's basis in the stock redeemed is also affected by whether an adjustment is required for losses of these subsidiaries availed of in consolidated returns which could not have been used if a separate return had been filed by that subsidiary.

(3) Whether Likins-Foster Honolulu Corp. and subsidiaries are entitled to deductions in computing the consolidated corporate income for:

(a) The amount of $2,700 paid by two of the subsidiaries for legal services in connection with the redemption by these subsidiaries of certain of their stock during the fiscal year ended June 30, 1957.

(b) The amount of $17,500 paid by the partnership T. Jack Foster and Sons, during the fiscal year ended June 30, 1958, to a law firm for services rendered on behalf of all the Foster Companies in 1956 and charged by the partnership of T. Jack Foster and Sons, to Likins-Foster Honolulu Corp. and subsidiaries.

(c) The amount of $500 of $1,944 paid by T. Jack Foster and Sons, a partnership, to a New York City attorney for an opinion with respect to how four of the subsidiaries of Likins-Foster Honolulu Corp. should proceed in condemnation negotiations with the United States, and allocated by the partnership to the four corporations whose properties were threatened with condemnation and a $5,000 legal fee and $9,000 of appraisal fees paid by the corporations whose properties were condemned in connection with the condemnation proceedings.

(4) Whether certain items paid by one of the subsidiaries of Likins-Foster Honolulu Corp. in connection with the acquisition from an unrelated party of certain properties were deductible in the fiscal year ended June 30, 1957, during which they were paid, or constituted a portion of the capital invested in the project and should therefore be used to increase the cost of the properties and the basis of the properties when they were subsequently sold.

(5) Whether certain portions of deductions claimed by Likins-Foster Honolulu Corp. and its subsidiaries as travel and entertainment expenses during the fiscal years ended June 30, 1958 and June 30, 1959, were properly disallowed by respondent.

(6)(a) Whether the consolidated income of Likins-Foster Honolulu Corp. and its subsidiaries for the fiscal year ended June 30, 1958, should be increased because of gains being realized by four of these subsidiaries upon condemnation in the latter part of 1957 of their properties by the United States Government, their bases in these properties at the date of the declaration of taking by the United States being less than the principal due on the mortgages outstanding thereon. In the alternative, if gain was not realized at the date of taking, whether these subsidiaries realized income because of the execution of agreements by the United States Department of Defense, the mortgagees and the Federal Housing Administration which made provisions with respect to payment of the mortgages on the properties of the subsidiaries which had been condemned by the United States. The four subsidiaries ceased to be affiliates of Likins-Foster Honolulu Corp. as of February 10, 1958.

(b) Whether the four subsidiary corporations whose properties were condemned by the United States realized a taxable gain during their fiscal years ended June 30, 1959, when they withdrew amounts which had been deposited by the United States with the District Courts at the time of the filing of the declaration of taking and at the time of the filing of an amended declaration of taking.

(c) If the four subsidiaries did realize a gain upon the withdrawal of the deposits from the escrow account, was this gain with respect to property sold within a year after the adoption of a plan of complete liquidation and therefore not subject to tax under the provisions of section 337?

(7) Whether respondent properly disallowed deductions for finance fees, interest, administrative and other corporate

expense claimed by Likins-Foster Honolulu Corp. and subsidiaries for the fiscal year ended June 30, 1959, in the amount of $325,000 because of petitioners' failure to show that the expenditures constituted ordinary and necessary business expenses.

(8) Whether Likins-Foster Honolulu Corp. had a gain during its fiscal year ended June 30, 1959, because of the transfer to it of the amount withdrawn from the deposits made by the United States in connection with the declaration of taking of property on condemnation of four of its subsidiary corporations because of the amounts withdrawn being turned over to it by the subsidiary corporation by which it was withdrawn as a distribution in liquidation.

(9) The transferees admit that they are liable as transferees and do not appear to contest the amount of that liability as ultimately alleged by respondent in his amendments to answers, but since this is not unmistakably clear we will include a finding as to the extent of the value of the assets transferred to each transferee as shown by the evidence.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Likins-Foster Honolulu Corp. (hereinafter referred to as Honolulu) and all the other corporations involved in these cases, except Cochiti Pumice Company, which is incorporated under the laws of New Mexico, and Central Development Co., Ltd., which is incorporated under the laws of Hawaii, are corporations organized and existing under the laws of Delaware. During all the years here involved all of these corporations maintained their books and records in the State of Oklahoma and filed their Federal income tax returns with the district director of internal revenue at Oklahoma City.

T. Jack Foster (hereinafter referred to as Foster) and Gladys Foster are husband and wife. T. Jack Foster, Jr.,

John R. Foster, and Richard H. Foster are sons of T. Jack Foster and Gladys Foster. Foster's sons will hereinafter be referred to by their first names. Foster and each of his sons kept their books and records and filed their Federal income tax returns during all the years here material with the district director of internal revenue at Oklahoma City.

There is no issue involved in this case with respect to the individual tax liability of Foster or any one of his sons. They are involved in this case because of respondent's determination that they are liable as transferees of Likins-Foster Ord Corp. (hereinafter referred to as Ord), Likins-Foster Monterey Corp. (hereinafter referred to as Monterey), Likins-Foster Biggs Corp. (hereinafter referred to as Biggs), and Likins-Foster El Paso Corp. (hereinafter referred to as El Paso).

For the fiscal years ended June 30, 1954, 1955, 1956, 1957, 1958 and 1959 Honolulu and subsidiaries filed consolidated Federal income tax returns.

Ord, Monterey, Biggs and El Paso became ineligible to file consolidated returns with Honolulu as of February 10, 1958, because Honolulu ceased as of that date to own 80 percent or more of the stock of those corporations. On or about October 5, 1959, each of those corporations filed a separate corporate Federal income tax return for the taxable period February 11, 1958 to June 30, 1958, and for the fiscal year ended June 30, 1959 with the district director of internal revenue at Oklahoma City. The subsidiary corporations that filed consolidated Federal income tax returns with Honolulu and the years for which the income of each was included in the consolidated returns are as follows:

Name of corporation	Taxable years for which such corporation filed a consolidated return with Honolulu
Aliamanu Homes, Ltd.	6-30-54 through 6-30-59
Likins-Foster Ord Corp.	6-30-54 through 2-10-58
Likins-Foster Monterey Corp.	6-30-54 through 2-10-58
Likins-Foster Biggs Corp.	6-30-54 through 2-10-58
Likins-Foster El Paso Corp.	6-30-54 through 2-10-58
Likins-Foster Olathe Corp.	6-30-55 through 6-30-59
Likins-Foster Topeka Corp.	6-30-54 through 6-30-59
Likins-Foster Salina Corp.	6-30-54 through 6-30-59
Cochiti Pumice Company	6-30-55 through 6-30-59
Lomita Homes, Inc.	6-30-54 through 6-30-59
Cardiff Homes, Inc.	6-30-54 through 6-30-59
Highland Park Homes, Inc.	6-30-54 through 6-30-59
Biggs Rental Co.	6-30-57 through 6-30-59
Foster Homes, Ltd.	6-30-57 through 6-30-59
Foster Development Corp.	6-30-57 through 6-30-59
Central Development Co., Ltd.	6-30-58 through 6-30-59

From and after February 10, 1958, all of the capital stock outstanding and issued by Ord, Monterey, Biggs, and El Paso was owned as follows:

Shareholder	Number of shares	Percent of stock owned
Likins-Foster Honolulu Corp.	119	79 1/3
T. Jack Foster	23 1/4	15 1/2
T. Jack Foster, Jr.	2 7/12	1 13/18
John R. Foster	2 7/12	1 13/18
Richard H. Foster	2 7/12	1 13/18

Foster is the president or chairman of the board of Honolulu and of each of its subsidiaries or affiliates. The corporations were organized in the period from 1950 to 1953 and all but one have been continuously engaged in the business of developing land, building dwellings, and renting or selling them. The one exception was Cochiti Pumice Co. which for a time was engaged in the development of pumice deposits in New Mexico.

Foster was initially connected in his various business enterprises with an individual named Likins. About 1955 Likins retired and his interests in the various enterprises were purchased by Honolulu and Foster's sons. Likins and Foster had operated a partnership which performed services for their corporations. After Likins' retirement, Foster and his sons formed a similar partnership under the name "T. Jack Foster & Sons." All of the building and development was done by the corporations.

Some of the developments carried out by the corporations were known variously as Wherry projects, 903 projects, 203 projects, and 213 projects. The numerals refer to sections of the Federal housing acts under which Federal financing for the projects was obtained. "Wherry project" refers to a project built in accordance with provisions of the Federal Military Housing Act (hereinafter sometimes referred to as the Wherry Act). Under this act a developer obtained a long-term lease of land from the Department of Defense for nominal rent for the purpose of constructing dwellings for rental to military personnel. The FHA guaranteed the loans obtained to construct the houses in Wherry projects, as well as those obtained in connection with nonmilitary projects. Each project was owned by a separate corporation primarily because of FHA or Wherry Act restrictions on the size of a mortgage which would be guaranteed for one corporation or the number of dwellings which one mortgage could cover. It was because of these restrictions that Ord and Monterey each built and leased a portion of the houses in a large project at Fort Ord, California, and El Paso and Biggs each built and leased a portion of the houses in the project at Biggs Air Force Base, Texas.

Reallocation of Gains on Sales of Houses
Issue 1(a)

Likins-Foster Topeka Corp. (hereinafter referred to as Topeka) constructed and owned 421 houses and duplexes

(486 units) in Topeka, Kansas, which were rented by it to personnel of Forbes Air Force Base from the time of completion until about July 1, 1956, at which date all of those properties were transferred to Ord, Monterey, Biggs, and El Paso (referred to collectively as the Wherry corporations) each grantee receiving by deeds certain definite lots.

It had been decided that Topeka should dispose of this property because the area was about to be taken within the city limits of Topeka, Kansas, which would cause an increase in taxes, and also because a new, large housing project was going to be built for the use of Forbes Air Force Base personnel.

It was decided that Topeka would transfer this property to four of its affiliated corporations before ultimate sale to outside parties.

Topeka was liable on the mortgages on these properties to the FHA by which the project had been initially financed. The FHA had previously assigned the mortgages on these properties to the Federal National Mortgage Association (hereinafter referred to as FNMA). Topeka transferred the houses subject to the mortgages to the Wherry corporations, but the transferees did not assume the mortgages. The books and records of Topeka show a sale price of the 421 houses and duplexes in an amount which exceeded its cost basis by $882,967.39. After the transfer Topeka owned no rental properties. The consolidated balance sheet for the year ended June 30, 1957, shows that Topeka had an asset entitled, "accounts receivable—intercompany-$736,816," and total assets of $774,097. This balance sheet shows no mortgage liability of Topeka and shows a "separate earned deficit —$88,290" and a "consolidated earned surplus—$628,639." After the transfer by Topeka of the 421 houses to the Wherry corporations there was no significant change in the operations carried on in Topeka, Kansas, with respect to

the properties transferred. There had been a small office staff of two or three people located in Topeka who handled the rentals and looked after upkeep of these properties. After the transfer of the houses to the Wherry corporations, one or two persons, including one of Foster's sons, were added to the office force in Topeka to handle the individual sales of the houses.

During the fiscal year ended June 30, 1957, Ord, Monterey, Biggs, and El Paso sold, by contracts of sale, all of the houses and lots.

A typical contract of sale entered into between a Wherry corporation and the purchaser of one of the houses provided that the property was sold subject to the FHA mortgage, that payments of the purchase price would consist of (1) monthly payments with respect to the FHA mortgage of principal and interest, insurance, taxes and mortgage insurance, and (2) initial payment and monthly payment of principal and interest to the seller on the amount of the sales price in excess of the amount remaining due on the FHA mortgage. The seller agreed to convey title to the purchaser upon payment in full of the amount due to the seller. The sales were completed in June 1957.

The books and records of the several corporations disclose that on June 29, 1957, Ord, Monterey, Biggs, and El Paso transferred and assigned the balances due on the contracts of sale acquired by them in connection with the sale of the 421 housing units to Honolulu as dividends, and in the case of Biggs, partially by the assumption by Honolulu of certain liabilities of Biggs to other members of the consolidated group.

The transaction was treated by Topeka on its books and records as an intercompany transaction and no part of the gain at which it transferred the properties was reported as taxable income on the consolidated return filed for the year ended June 30, 1957. Topeka reported a loss of $63,439 for

consolidated purposes that year which was determined as follows: Topeka reported a gross income of $928,844, which included $1,221,743 from "sale of houses and lots" plus amounts of income from other sources, less $299,945, "cost of houses and lots sold." Topeka reported expense deductions of $109,316, leaving a net income of $819,528. An amount of $882,967 was eliminated as "intercompany sales," leaving a loss of $63,439.

The books and records of the Wherry corporations disclose that the properties transferred to them from Topeka sold for an amount of $387,654 in excess of the amount paid therefor to Topeka. The Wherry corporations reported the sales as installment sales on the consolidated return for the year ended June 30, 1957, as follows:

	Units sold	Profit	Taxable gain for fiscal year
Ord	106 houses		
	40 duplexes	$ 440,196	$ 95,314
Monterey	91 houses	300,003	142,455
Biggs	94 houses	274,965	110,098
El Paso	80 houses	255,458	124,974
	411 buildings*	$1,270,622	$472,841

*It is stipulated that 421 buildings were sold and the variance between the 411 buildings sold and the stipulated figure is unexplained in the record.

The amount, $472,841, shown above, represents down payments received at the time of sale, plus collections made on the contracts of sale during the fiscal year ended June 30, 1957.

The Wherry corporations reported gross and net taxable income for the fiscal year ended June 30, 1957, as follows:

	Gross income	Deductions	Net income
Ord	$668,193	$582,441	$ 85,753
Monterey	639,271	553,178	86,093
Biggs	521,748	415,404	106,344
El Paso	527,934	413,354	114,580

As of June 30, 1956, the Wherry corporations each had net operating loss carryovers from years for which each had filed a separate return. The following schedule shows the part of such carryovers which is attributable to the taxable year ended December 31, 1952, the total carryover available to each of the Wherry corporations for the fiscal year ended June 30, 1957, and the excess (deficiency) of such total carryover over (below) the net income reported by each of the corporations for the fiscal year ended June 30, 1957.

	Loss attributable to 1952	Total separate net operating loss carryover	Excess (deficiency) over income shown for fiscal year ended June 30, 1957
Ord	$30,889	$ 81,875	($ 3,878)
Monterey	10,711	123,139	37,046
Biggs	49,681	106,418	74
El Paso	58,187	114,945	365

Topeka had no net operating loss carryover from its separate return years at June 30, 1956.

The consolidated group reported aggregate taxable income of $218,862 for the year ended June 30, 1957, and claimed a net operating loss deduction of $870,461, which was applied as hereinafter set forth, leaving no consolidated taxable income and a consolidated net operating loss carryover to subsequent years. The net operating loss deduction figure was composed of separate net operating loss carryovers totaling $535,747 and a consolidated net operating loss carryover of $334,714.

In his notice of deficiency, respondent reallocated the reported installment gain of $472,841 to Topeka. This reallocation, together with certain minor adjustments, resulted in separate taxable incomes and (losses) for Topeka and the Wherry corporations as follows:

Topeka	$409,401.40
Ord	(4,069.39)
Monterey	(49,569.67)
Biggs	(1,647.27)
El Paso	(8,286.53)

Proper Method to Be Used in the Application of Separate Net Operating Loss Carryovers

Issue 1(b)

As of June 30, 1956, Ord, Monterey, Biggs, and El Paso had total net operating loss carryovers available for use in the fiscal year ended June 30, 1957, from years for which separate returns had been filed as set forth in our findings under issue 1(a).

The following table shows the year-end dates on which certain other subsidiaries of Honolulu first joined in filing consolidated returns and the separate loss carryover of each remaining for use in consolidated returns filed for the year ended June 30, 1957, and subsequent years.

Subsidiary	Date of first consolidated return	Loss carryover at date of affiliation	Separate loss carryover at June 30, 1956
Aliamanu Homes Limited	June 30, 1954	$82,144.58	—
Likins-Foster Olathe Corp.	June 30, 1955	38,545.16	$38,545.16
Topeka	June 30, 1954	87,175.00	—
Likins-Foster Salina Corp.	June 30, 1954	39,851.35	39,851.35
Cardiff Homes, Inc.	June 30, 1954	34,689.47	—
Cochiti Pumice Co.	June 30, 1955	38,764.07	—
Biggs Rental Co.	June 30, 1957	17,666.45	17,666.45*
Foster Homes, Ltd.	June 30, 1957	1,152.78	1,152.78

*This loss carryover was as of the close of the separate fiscal year of Biggs Rental Co., ended August 31, 1956.

Honolulu had no separate loss carryover to June 30, 1954, the close of the first year for which the group filed a consolidated return, nor at June 30, 1956, the end of the year preceding the first year here in issue.

Foster Development Corp. and Central Development Co., Ltd., which filed their tax returns with the consolidated group for the first time for the years ended June 30, 1957, and June 30, 1958, respectively, are not shown to have any separate loss carryovers as of the date their incomes or losses were first included in the consolidated return.

Lomita Homes, Inc. (hereinafter referred to as Lomita) and Highland Park Homes, Inc. (hereinafter referred to as Highland Park) each of which joined in filing a consolidated return with Honolulu and subsidiaries for the fiscal year ended June 30, 1954, had separate net operating loss carryovers for their fiscal years ended March 31, 1954, available for use in subsequent years in the respective amounts of $66,899.32 and $13,559.22.

Petitioners in computing taxable consolidated net income would apply the separate loss carryover of a particular subsidiary to the separate income of that subsidiary as shown prior to determining the consolidated net income or loss. The result of the use of this method was to increase the amount of the consolidated loss carryover available for use in subsequent years over what it would have been if no separate losses had been used for years in which the consolidated group sustained a consolidated loss prior to applying the net operating loss carryover, or the amount of the separate losses used had been limited to a portion of the separate net income in those years where there was a consolidated net income composed of separate incomes of some subsidiaries and separate losses of other subsidiaries prior to applying a net operating loss carryover.

Respondent determined that no separate net operating loss carryover should be used to reduce separate net income for those years in which there was a consolidated net loss prior to application of any net operating loss carryover.

As of June 30, 1956, the parties differ with respect to the separate net operating loss carryovers of the following corporations, each party showing the separate loss carryovers as of that date in the amount indicated:

Name of subsidiary	Amount of separate net loss carryover as of June 30, 1956, available to be carried to a subsequent year or years — Respondent's determination	Petitioner's computation
Lomita	$ 6,956.19	None
Highland Park	13,559.22	$12,154.82

In 1954 and 1955, the group had combined net losses before deduction of a net operating loss carryover of $224,615.30 and $245,204.10, respectively. Lomita deducted its separate net operating loss carryover from its separate net income of $20,916.36 in the fiscal year ended June 30, 1955, and absorbed the remainder of its separate net operating loss carryover by deducting it from its separate net income for the fiscal year ended June 30, 1956, and Highland Park deducted a portion of its separate net operating loss carryover from its separate net income of $1,404.40 for the fiscal year ended June 30, 1954.

Respondent determined that no portion of the separate net operating loss carryover of Lomita and Highland Park could be used for the fiscal years ended June 30, 1954, and 1955 in which the combined incomes or losses of the entire group resulted in a combined net loss, and that the remaining carryover of Lomita was not totally absorbed at June 30, 1956.

In the fiscal year ended June 30, 1957, ten of the affiliates reported separate net incomes which totaled $660,273. Six of the affiliates reported separate net losses, which totaled $441,411.24. The combined net incomes and losses as reported by the affiliated group was an income of $218,861.76, which figure was shown on the consolidated income tax return as consolidated net income before deduction of any net operating loss. On petitioners' consolidated return, net operating losses were not applied against the consolidated net income of the affiliates as shown on the face of the return, but the separate net operating loss carryovers of affiliates having separate net incomes for the fiscal year ended June 30, 1957, were applied against the total separate incomes of such affiliates. By this method separate net operating losses totaling $447,181.50 were absorbed as shown in the following table.

Corporation	Net income	Separate carryover used
Aliamanu Homes, Limited	$119,788.30	None
Ord	85,752.61	$ 81,874.70
Monterey	86,092.58	86,092.58*
Biggs Rental Co.	106,343.88	106,343.88*
El Paso	114,580.12	114,580.12*
Salina	39,362.84	39,362.84*
Cochiti Pumice Co.	4,145.97	—
Highland Park	1,260.93	1,260.93*
Biggs Rental Co.	20,408.67	17,666.45
Honolulu	82,537.10	None
Total	$660,273.00	$447,181.50

*Indicates that the separate net operating loss available to the corporation was larger than its net income.

The following table shows a summary of the method used by petitioners in applying net operating loss carryovers in their consolidated return for the fiscal year ended June 30, 1957.

Total income of the 10 affiliates showing separate gain	$660,273.00
Separate carryovers used to offset these separate gains	447,181.50
Unabsorbed separate gains	$213,091.50
Total current operating losses of 6 affiliates reporting separate losses	(441,411.24)
Unabsorbed current losses	($228,319.74)

The unabsorbed current loss of $228,319.74 was considered by the affiliated group to be a consolidated loss for the fiscal year 1957, and it was added to consolidated loss carryovers from previous years to make up the consolidated loss carryover to the fiscal year 1958.

The consolidated group employed the same method in the tax returns filed for the fiscal years ended June 30, 1958 and 1959 with the following results:

	1958	1959
Total income of affiliates reporting separate gain	$169,668.68	$594,375.66
Separate carryovers used to offset these separate gains	4,971.69	2,386.08
Unabsorbed separate gains	$164,691.99	$591,989.58
Total current operating losses of affiliates reporting losses	(161,539.29)	(40,180.19)
Excess of unabsorbed income over losses	$ 3,152.70	$551,809.39

In 1958 and 1959, there being no "consolidated loss" resulting from the application of the first two steps as described for the fiscal year 1957, the excess gain figures were reduced to zero by application of consolidated carryovers of $563,033.63 and $559,880.93, respectively, resulting in no taxable consolidated net income.

Respondent attached to his notice of deficiency a lengthy schedule showing his computation of the portion of the separate losses available for use by each subsidiary which had separate income in the fiscal years ended June 30, 1957, 1958, and 1959, which, on brief, respondent says is a result of applying the following formula:

(Subsidiary's separate loss carryover included in the consolidated net operating loss deduction)

divided by

(The total separate loss carryovers included in the consolidated net operating loss deduction)

times

(The consolidated taxable income for the year before deduction of the consolidated net operating loss deduction).

Inclusion in Income of Parent Corporation of Capital Distributions or Redemptions of *Stock by Ord, Monterey and Highland Park.*

Issues 1(c) and 2

As of June 30, 1955, Honolulu owned all of the outstanding stock of Ord, Monterey and Highland Park. The number

of shares outstanding and Honolulu's bases in the voting (class A) stock were as follows:

	Voting (Class A) No. of Shares	Basis	Nonvoting (Class B) No. of Shares
Ord	850	$ 85,000	100
Monterey	2,150	215,000	100
Highland Park	100	17,307	1,000

In accordance with an FHA requirement, each of the Wherry corporations had two classes of capital stock, class A and class B. Class A stock represented the capital required for the period beginning with construction and ending after the projects were fully constructed and class B stock represented working capital. Class A stock was callable only with approval of the FHA. Such approval was obtained with respect to the class A stock of Ord and Monterey prior to the date of the redemption by these corporations of their class A stock during the fiscal year ended June 30, 1957.

During the fiscal year ended June 30, 1956, Ord and Highland Park distributed in cash to Honolulu the amounts of $238,500 and $17,478, respectively. Monterey distributed $36,000 in cash to Honolulu during that same year. For the fiscal years ended June 30, 1955 and 1956, Ord, Monterey and Highland Park showed deficits in their separate earned surplus accounts contained on the balance sheets filed with the consolidated income tax returns as follows:

	Ord		Monterey		Highland Park	
	Year Ended 6/30/55	Year Ended 6/30/56	Year Ended 6/30/55	Year Ended 6/30/56	Year Ended 6/30/55	Year Ended 6/30/56
Separate earned deficit	$119,188	$119,188	$123,139	$123,139	$13,559	$13,559
Consolidated earned deficit	$ 40,022	$303,751	$104,837	$209,739	$ 8,895	$26,415

The separate income or (loss) reported by Ord, Monterey and Highland Park and the consolidated income or (loss)

reported in the consolidated returns filed for the years ending June 30, 1954, 1955 and 1956 were as follows:

Year Ended June 30	Ord	Monterey	Highland Park	Consolidated
1954	($ 8,794)	($23,877)	$ 1,404	($224,615)
1955	($27,446)	($77,656)*	($10,299)	($245,204)
1956	($28,980)	($72,090)	($ 42)	$449,800

*Respondent has adjusted the reported loss to ($78,664).

During the fiscal year ended June 30, 1957, Ord redeemed its 850 shares of class A, common stock held by Honolulu and Monterey redeemed its 2,150 shares of class A, common stock held by Honolulu paying Honolulu $70,000 and $200,000, respectively, in redemption. Ord and Monterery continued in active business after the redemption until on or about November 1, 1957, at which time their principal properties were condemned by the United States of America.

For the fiscal year ended June 30, 1956, Honolulu reported taxable income of $1,024,421.12 on the consolidated return and reduced this figure by $887,527 denominated "intercompany dividends". Respondent determined that Honolulu realized additional taxable gain in the fiscal year ended June 30, 1956, of $153,671, which was the excess of the amount of cash it received from Ord and Highland Park in 1956 over Honolulu's bases in the stocks of those two corporations, and that the net operating loss carryover available at June 30, 1957, should be reduced accordingly. Respondent determined that Honolulu received long-term capital gain in the fiscal year ended June 30, 1957 on the redemption of the Ord and Monterey stock, and that, in computing such gain, Honolulu's basis in the Ord and Monterey stock should be reduced by the amounts of prior distributions which were not dividends. In an amendment to his answer respondent alleged that the basis of Honolulu in the stock of Monterey should be reduced by the amounts of losses which were sus-

tained during the years Monterey filed consolidated returns with Honolulu to the extent that such losses were availed of beyond the degree to which Monterey could have used those losses if it had filed separate returns for the respective years. The amount of losses so availed of as alleged by respondent were $95,330.54.

Claimed Deductions for Legal Fees and Appraisal Fees
Issue 3

(a) During the fiscal year ended June 30, 1957, Ord paid $700 and Monterey paid $2,000 as legal fees to a law firm in Washington, D. C. which represented them before the FHA in connection with the obtaining of permission to redeem stock. The same firm had been hired on previous occasions by various of the Foster interests for similar legal services. The $2,700 was deducted as business expense in the computation of the consolidated income of Honolulu and subsidiaries for the fiscal year ended June 30, 1957. Respondent determined in his notice of deficiency that the amounts paid for legal services in connection with the stock redemptions should be added to the cost of the treasury stock acquired by the redeeming corporation.

(b) In the taxable year ended June 30, 1958, payments were made by the partnership, T. Jack Foster & Sons, to Lytle, Johnston & Soulé in the amount of $20,000, to Lewis Orgel in the amount of $1,944, and to Sincerbeaux & Shrewsbury in the amount of $5,000, all for legal services rendered.

T. Jack Foster & Sons paid Lytle, Johnston & Soulé the $20,000 in May 1958, in response to a bill "To fee for services rendered to all Foster Companies for the year 1956." The bill, dated May 21, 1958 was submitted by letter dated May 20, 1958. The partnership allocated $17,500 of the amount of this legal fee to Honolulu and its subsidiaries. This law firm had been counsel to the Foster organizations since 1950. Roy

C. Lytle who represented petitioners at the trial of the instant case was one of the partners in this law firm. The fee paid in 1958 with respect to services performed in 1956 did not relate to the condemnations of the Fort Ord and Biggs Air Force Base projects.

(c) T. Jack Foster & Sons paid Lewis Orgel, a New York City attorney, $947 on February 19, 1958, $947 on March 5, 1958 and $50 on March 15, 1958, a total of $1,944. Foster considers Lewis Orgel to be an expert on condemnation law. After learning that the United States might proceed to condemn all projects built under the Wherry Act, interested project owners met in Washington and arranged for the services of Orgel to prepare an opinion on the procedure to be followed in condemnation negotiations. His fee was $1 per unit in each project and the amount paid by each of the Wherry corporations which were Honolulu's subsidiaries was allocated in that manner. Respondent in his notice of deficiency disallowed as a deduction for a business expense $500 of the payment to Lewis Orgel. The notice does not state whether this amount represented a partial disallowance of the fees allocated to each of the Wherry corporations or a total disallowance as to one of those corporations.

In 1958 Monterey paid Sincerbeaux & Shrewsbury a legal fee of $5,000. This firm was counsel to Greenwich Savings Bank, the assignee under the mortgage on the Monterey project. Greenwich Savings Bank filed a cross-claim for attorneys' fees of $15,000 in the Monterey-Ord condemnation proceedings. The $5,000 was paid as a compromise settlement of that claim. Respondent disallowed the deduction of the $5,000 as a business expense.

T. Jack Foster & Sons paid Leonard J. Cowley $1,000 on December 6, 1957 and Biggs paid him $3,000 on February 14, 1958. Biggs also paid Marshall and Stevens $5,000 on February 14, 1958. All of these payees are professional real estate appraisers. Respondent disallowed as a deduction for

a business expense the $9,000 paid to these real estate appraisers.

Respondent allowed as selling expenses, in computing gain on the payments in condemnation of the Wherry projects, the $500 disallowed of the amount paid to Lewis Orgel, the $5,000 paid Sincerbeaux & Shrewsbury and the $9,000 paid to the real estate appraisers.

Expenses in Connection with the Acquisition of the San Jose Project

Issue 4

On June 23, 1955, T. Jack Foster & Sons, the partnership, (hereinafter sometimes referred to as Foster & Sons or Foster partnership), agreed to guarantee a bank loan of $2,100,000 which was to be obtained from Central Valley Bank by California Development Co. (hereinafter referred to as California Development), a partnership of four individuals which had no connection with Honolulu or any of its subsidiaries, for the purpose of acquiring and developing land near San Jose, California. Foster & Sons was to receive as consideration $500 for each house and lot sold by California Development plus $150 per house from "water refunds."

California Development defaulted on the bank loan. The "default" of California Development was precipitated by Foster's discovery of bad faith dealings on the part of California Development, such as bloating the book cost of assets by transferral through straw parties. Foster threatened to have the bank foreclose on the loan if California Development continued with the project.

California Development, on July 26, 1956, transferred all interest in the San Jose property to Foster, who transferred it to Lomita. Foster and Lomita each assumed the liabilities of California Development with the transfer of the assets. Lomita gave its note to the bank to cover the indebtedness of

California Development, which at the time was $536,221.97, including interest of $66,257.30 charged on August 1, 1955 and interest of $14,687.32 charged on June 13, 1956. California Development had obtained FHA and FNMA commitments on the project for which a fee was charged which would have permitted the borrower to draw a stated amount as the project progressed. The full amount of the loan had not been drawn by the borrower when Lomita acquired the assets. The portion of the commitment or loan application fee applicable to this unused amount was $38,215.80.

Since the entire commitment fee had been deducted from the loan when it was made, the loan assumed by Lomita included the $38,215.80 portion of the commitment fee applicable to the undrawn portion of the loan. The officers of Lomita decided that the existing development plan was not a good one and scrapped the plan. Because of this change of plans Lomita received no benefit from the portion of the commitment fee applicable to the unused portion of the loan.

Lomita incurred an expense of $1,650.62 in the fiscal year ended June 30, 1957, for engineering fees and related costs in connection with the new plans which were drawn up after the original ones were scrapped.

Petitioners claimed a deduction of $120,811.04 as "interest expense" of Lomita in the fiscal year ended June 30, 1957, composed of the following amounts:

Administration and miscellaneous San Jose operations	$ 66,257.30
Administration and interest San Jose operations	14,687.32
FHA and FNMA commitment fees	38,215.80
Other costs of project	1,650.62
	$120,811.04

Respondent disallowed the deduction and determined that the $120,811.04 should be allocated to the basis of the units in the San Jose project and allowed additional cost-of-sale deductions in each of the years here involved because of this adjustment in the following amounts for the years indicated:

Year ended June 30	Additional cost of sale
1957	$ 2,793.32
1958	53,771.41
1959	48,883.10
	$105,447.83

Deductions for Travel and Entertainment Expenses
Issue 5

The various Foster organizations operated over a wide geographic area, with projects in Kansas, Texas, California, Hawaii, and other widely distant locations. Travel expenses for officers and employees of the various corporations were incurred in each year here in issue in carrying on the affairs of the various corporations.

When the United States began condemnation proceedings against the Fort Ord and Biggs Air Force Base projects, Foster went with certain of his employees to Fort Ord and Biggs Air Force Base to inventory items of personal property (such as water heaters and refrigerators) which were kept at the location of those projects for replacement and to repair those items in the various units of the project, which were in present need of repair. The personal property was part of the property under condemnation. Foster carried cash on these occasions and paid in cash for repair parts needed for repair work but not contained in the inventory at the project location, because local dealers would not extend credit to the Wherry corporations in light of the pending condemnations. At the same time inspection of all housing units was made jointly by a Foster employee and a Government employee, to determine the general condition of each unit involved in the condemnation negotiations. Because of the work done in this respect by Foster and his employees the condemnation award was from $25,000 to $30,000 higher than it would otherwise have been.

Employes who traveled for the Foster corporations were usually reimbursed by the Foster partnership. During the years 1956 through 1959 the Foster partnership expended the following amounts for travel and entertainment and allocated the indicated part of the amounts so expended to Honolulu:

Calendar year ended December 31*	Paid by T. Jack Foster & Sons	Charged to Likins-Foster Honolulu Corp.*	Claimed by T. Jack Foster & Sons
1956	$ 5,749.86	None	$ 5,749.86
1957	22,854.20	$20,082.89	2,771.31
1958	20,301.50	10,000.00	10,301.50
1959	15,981.78	None	15,981.78

*The calendar years ending December 31 are in the fiscal years of the corporation ending June 30 of the following year.

Respondent in his notice of deficiency disallowed deductions totaling $8,444 in the fiscal year of Honolulu and subsidiaries ended June 30, 1958, as follows:

Honolulu	$4,344
Ord	800
Monterey	800
Biggs	1,300
El Paso	1,200

Of the total of $4,100 deductions claimed by the Wherry corporations disallowed by respondent, he allocated $1,500 as expenses of sale in computing the gain to Biggs and El Paso on the condemnation of the El Paso-Biggs project, increasing the basis of the project by that amount.

Respondent in his notice of deficiency disallowed $15,960.61 of the expense for travel and entertainment claimed as a deduction on the consolidated return of Honolulu and subsidiaries for the fiscal year ended June 30, 1959, as not representing ordinary and necessary business expenses. The amount of $10,000 included in this disallowance of $15,960.61 is the $10,000 portion of travel and entertainment expenses paid by the Foster partnership in the calendar year 1958 and allocated to Honolulu in its fiscal year ended June 30, 1959.

Gains from Condemnation

Issue 6

Ord and Monterey entered into agreements with the Secretary of the Army in 1951 and 1952, respectively, in accordance with the provisions of the Wherry Act for the lease of land and construction of 500 houses each at Fort Ord Military Reservation, Monterey County, California. Biggs and El Paso entered into similar lease agreements in 1950 with the Secretary of the Air Force for projects at Biggs Air Force Base, El Paso County, Texas, for the construction of 400 houses each. Construction was performed in accordance with the contract between the lessee corporations and T. Jack Foster and V. B. Likins, partners. The construction was financed under Title VIII of the National Housing Act as in effect prior to the enactment of the Housing Amendments of 1955.

The four leases were similar. Each was for a term of 75 years, at an annual rental of $100. The leases were subject to termination on default and were expressly for the purpose of erecting, maintaining and operating housing projects in accordance with plans and specifications set forth by the contracting department and the Federal Housing Commissioner. Use and occupation of the houses constructed were subject to rules and regulations set forth by the Commanding Officer of the post or base.

The Monterey lease provided for termination without cause, but only after 50 years and 6 months of the term had expired and the FHA mortgage interest had terminated. The other three leases did not provide for termination without cause.

On October 30, 1957, the United States filed in the United States District Court for the Western District of Texas a complaint in condemnation and declaration of taking against Biggs and El Paso and deposited $2 as estimated just compensation. The deposit was increased on June 6, 1958, by $337,998 representing $171,500 for Biggs and $166,500 for El Paso. The District Court entered judgment on the date

of filing that title to the property was in the United States and that just compensation therefor would be ascertained and awarded in the proceeding before it.

A similar complaint and declaration of taking were filed on November 1, 1957, in the United States District Court for the Northern District of California against Ord and Monterey with respect to the Ord-Monterey project and a deposit of $782,053 was made as estimated just compensation of $318,827 for Monterey and $463,226 for Ord.

Each complaint and delclaration of taking filed in the above actions alleged that the United States was proceeding under 46 Stat. 1421, 40 U. S. C. 258a and that the "estate," or "property," taken was all right, title and interest of the Wherry corporations arising out of their leases from the Government, together with improvements thereon, and "subject to the interest of" the mortgagee or mortgagees. The encumbrances on the property were listed in the allegations of the complaints and declarations. The Wherry corporations each filed a notice of appearance shortly after the complaints and declarations of taking had been filed in which each stated that it made no objection to the taking of its property, but demanded a jury trial as to just compensation. None of the Wherry corporations reached a voluntary settlement with the United States on the issue of just compensation prior to the rendition of jury verdict and judgment.

The Biggs and El Paso projects had been financed through deeds of trust (referred to herein as mortgages) to the benefit of the Republic National Bank of Dallas which mortgages were later assigned to the New York Life Insurance Co. (hereinafter referred to as NYLIC). The Ord project had been financed by a deed of trust and a chattel mortgage through the same bank and both were assigned to NYLIC. The Monterey project was financed through a deed of trust and two chattel mortgages to the same bank and all were ultimately assigned to the Greenwich Savings Bank, New York City (hereinafter referred to as Greenwich). The amounts of principal due on each of the mortgages at the date the condemnation suits were filed and amounts on de-

posit with the mortgagee in escrow and as prepayments with respect to each mortgage were:

	Principal Due	Escrow and prepaid amounts
Ord	$4,017,879.35	$167,787.43
Monterey	4,101,516.41	109,919.48
El Paso	3,182,707.04	212,014.45
Biggs	3,182,707.04	211,218.05
		$700,939.41

The books of the Wherry corporations showed the following adjusted bases in the condemned assets on the date the condemnation suits were filed:

Ord	$3,342,983.40
Monterey	3,494,850.61
Biggs	2,672,706.50
El Paso	2,654,696.72

Greenwich, pursuant to rights which it had as assignee, filed a cross-claim in the District Court for the Northern District of California against Monterey for $15,000 attorneys fees on April 10, 1958. This claim was settled in June 1958 for $5,000. Greenwich withdrew its counterclaim and any claim to any compensation due Monterey by stipulation filed August 18, 1958.

At some time subsequent to the commencement of the condemnation suit, the United States Government, acting through the Federal Housing Commissioner, and either the Secretary of the Army or the Air Force, entered into "three-party agreements" with NYLIC and Greenwich, which were executed "as of December 27, 1957" and "as of November 1, 1957" in which the United States assumed the liabilities of the Wherry corporations to the mortgagees. These documents bear acknowledgment dates as follows:

Assumption of liability of—	Secretary of Army or Air Force	Federal Housing Commissioner	NYLIC or Greenwich
Ord	Mar. 3, 1958	Mar. —, 1958*	Feb. 21, 1958
Monterey	June 23, 1958	July 8, 1958	June 17, 1958
Biggs	Dec. 27, 1957	Jan. —, 1958*	Jan. 16, 1958
El Paso	Dec. 27, 1957	Jan. —, 1958*	Jan. 16, 1958

*Day of month illegible on exhibit.

The Wherry corporations did not sign these documents. Supplemental agreements were submitted to Biggs and El Paso by NYLIC which stated that in consideration of the assumption by the United States of the mortgages, NYLIC would release Biggs and El Paso of their liability. NYLIC signed these agreements under acknowledgment of June 5, 1958, and transmitted them to Biggs and El Paso under cover letters dated July 11, 1958. By letter dated July 14, 1958, counsel to Biggs and El Paso declined for his client to execute the proposed agreements, stating as a reason that the corporations were protected by the three-party agreements.

The consolidated group did not report any income from the condemnations in the return filed for the fiscal year ended June 30, 1958.

NYLIC disclaimed any interest in the Biggs-El Paso proceeding at some time prior to August 20, 1958, and in the Ord-Monterey proceeding by a stipulation dated January 30, 1958, and filed August 18, 1958.

On August 19, 1958, Ord and Monterey filed motions for withdrawal of the funds deposited by the United States in court. Biggs and El Paso filed similar motions on August 20, 1958. An order for the payment of deposits of $463,226 and $318,827 to Ord and Monterey, respectively, was entered by the United States District Court in California on August 21, 1958. Those amounts were withdrawn pursuant to the order on August 27, 1958. An order for the payment of $171,500 and $166,500 to Biggs and El Paso, respectively, was entered by the United States District Court in Texas on August 25, 1958. Those amounts were withdrawn pursuant to the order on September 2, 1958. The cash withdrawn from the courts was deposited in Honolulu's bank account.

Plans of liquidation were adopted on August 11, 1958, by each of the Wherry corporations. From and after February 10, 1958, as heretofore set forth, the stock ownership of each of the Wherry corporations was 79 1/3 percent in Honolulu, 15 1/2 percent in Foster, and 1 13/18 percent in each of the three Foster sons. The Wherry corporations each reported

the adoption of the plan of liquidation on its separate Federal income tax return for its taxable year ended June 30, 1959, as a liquidation under section 337(a). Each statement related that the principal asset of the corporation was leasehold improvements on which condemnation proceedings were under way, that certain deposits had been received by them during the year but that gain could not yet be computed and, if it could, it was not taxable to the corporations. The liquidations were completed on August 8, 1959.

On January 21, 1960, a jury verdict was returned in the California District Court condemnation proceeding that the just compensation due Ord and Monterey for their property taken by the United States Government was $1,106,000. On December 4, 1959, the parties had filed a stipulation with the Court in accordance with which a written pretrial order and judgment had been entered that the United States pay Monterey $22,006.16 for prepaid premiums on mortgage insurance and escrowed deposits and pay Ord $16,641.20 for prepaid premiums on mortgage insurance. On January 13, 1960, the Court had entered an order that the United States pay Monterey and Ord, for proration between them, $49,534.58 as compensation for personal property taken from those two corporations on November 1, 1957. Determination of interest on the amounts to be paid for prepaid premiums and escrow deposits was reversed.

Ord and Monterey filed a motion for a new trial which was denied on June 22, 1960.

The judgment of the Court in accordance with the jury verdict was entered on June 23, 1960. A consolidated order of payment was entered June 29, 1960, which briefly recapitulated the amounts paid to and the amounts remaining due Ord and Monterey under all judgments. The parties had stipulated that the trial and award be joint and that Ord and Monterey would prorate the joint award as they saw fit. The consolidated order noted that the total amount of all judgments was $1,194,181.94 and that interest was due on part of that amount. The Court ordered payment by the United

States to Ord and Monterey of $467,813.14; the amount remaining due to them including interest. Ord and Monterey appealed from the decision of the District Court to the United States Circuit Court of Appeals for the Ninth Circuit. The Circuit Court affirmed the judgment of the District Court on October 1, 1962. The amount of $467,813.14 remaining due to Ord and Monterey under the judgment and order of payment of the District Court is computed as follows:

Total compensation due Monterey and Ord for taking of property per the verdict of the jury		$1,106,000.00
Amount due Monterey and Ord for taking personal property		49,534.58
Due Monterey and Ord for mortgage insurance paid		38,647.36
Total due Monterey and Ord as of 6-29-60		$1,194,181.94
Amount previously paid		782,053.00
Balance due 6-29-60, exclusive of interest consisting of:		
(1) Additional just compensation awarded by jury	$323,947.00	
(2) Agreed amount due for taking of personal property	49,534.58	
(3) Mortgage insurance refund due Monterey and Ord	38,647.36	
Total principal due		$ 412,128.94
Add:		
(1) Interest at 6% on $373,481.68 from November 1, 1957; and		
(2) Interest at 6% on $38,647.36 from January 13, 1960		55,684.20
Total ordered paid June 29, 1960		$ 467,813.14

The District Court in Texas entered a judgment pursuant to a jury verdict in the Biggs-El Paso case on August 7, 1962, in favor of Honolulu, Foster, and Foster's sons in the amount of $1,700,000. The shareholders of Biggs and El Paso had been made parties defendant after liquidation of Biggs and El Paso under the plan of liquidation adopted August 11, 1958. Since the United States had previously deposited $338,000 in court, the amount ordered to be paid

was $1,362,000 plus interest. The United States deposited $1,765,920.57 with the Court on August 15, 1962, and that amount was withdrawn by the shareholders of Biggs and El Paso on August 29, 1962.

Neither Honolulu and subsidiaries nor Ord, Monterey, Biggs, or El Paso in separate returns reported any income from gain on the condemnation of the properties of the Wherry corporations in any of the years here in issue.

Respondent in his notice of deficiency determined that Honolulu and subsidiaries received income for their fiscal year ended June 30, 1958, in that each of the Wherry corporations had a gain at the date of the filing by the United States of the complaint and declaration against it to the extent of the excess of the mortgage indebtedness on its property over its basis therein. Respondent also determined that each of the Wherry corporations had income in its fiscal year ended June 30, 1959, from gain on the condemnation when it withdrew deposits from escrow and determined that Honolulu, Foster, and Foster's sons were liable as transferees for the amounts of these deficiencies plus interest. Respondent also determined that Monterey and Ord each had a gain in its separate fiscal period from February 11 through June 30, 1958, from the condemnation of its properties to the extent of the excess of the balance due at the date of filing of the complaint and declaration on its mortgages on its properties over its basis therein and that Honolulu, Foster, and Foster's sons were each liable as transferees for the deficiencies so determined. Respondent recognized that this determination was a duplication of the deficiencies determined against Honolulu and subsidiaries for the fiscal year ended June 30, 1958, because of this same transaction.

Claimed Administrative Expense Deduction
Issue 7

Honolulu acquired a leasehold in Honolulu, Hawaii,[5] and built a housing project of 250 houses, called Harbor Heights,

5. Fee simple estates are usually not obtainable in Hawaii due to the concentration of land holdings in large estates. The typical form of acquiring property for private use is by long-term lease.

thereon. Honolulu acquired a second leasehold on which 525 houses were built. This project was called Foster Village. Foster Village was developed by Foster Development Corp. (hereinafter referred to as Foster Development) and the construction was done by Foster Homes, Ltd. (hereinafter referred to as Foster Homes). Foster negotiated the leases and obtained the financing for Harbor Heights and Foster Village. He personally guaranteed the financing on the two developments. Interim financing was obtained from the Republic National Bank of Dallas and the Bishop National Bank. Permanent financing was obtained through FNMA. The permanent financing on Foster Village was approximately $5,000,000. Foster personally advanced some funds in connection with the development of Harbor Heights and Foster Village.

Foster Homes was incorporated on December 13, 1955, under the laws of Delaware with $10,000 paid-in capital on 1,000 common shares. Foster Development was incorporated on February 13, 1956, under the laws of Delaware with $10,000 paid-in capital on 1,000 common shares. Honolulu owned all of the outstanding stock of both of these corporations.

The books of Honolulu, Foster Development, and Foster Homes show the following adjusting journal entries as of June 30, 1959:

Corporation charged or credited	Expense charged or credited	Amount
Honolulu	Finance fees	$ 50,000.00
Honolulu	Finance fees	30,000.00
Honolulu	Administrative expense	(100,000.00)
Foster Development	Administrative expense	105,000.00
Foster Homes	Administrative expense	75,000.00
Foster Homes	Interest expense	22,648.93
Foster Homes	Other corporate expense	142,351.07
		$325,000.00

The amount of $325,000 represents payments of $50,000 to Foster in December 1958, of $200,000 to Foster on June 30, 1959, and of $75,000 to Foster & Sons for the year ended June 30, 1959. Foster reported the payments to him as income on his personal income tax returns for the years 1958 and 1959 and Foster & Sons reported the payment to it on its partnership return of income for the year 1959. The returns for the taxable years ended June 30, 1957, 1958, and 1959 filed by the various corporate petitioners disclose no salary paid to Foster. Foster received no salary from Foster Homes or Foster Development during any period here pertinent.

On the consolidated income tax return filed for the fiscal year ended June 30, 1959, deductions were claimed in the total amounts of $260,000 for administrative expense, $22,648.93 for interest, and $142,351.07 for "other corporate expenses."

In his notice of deficiency respondent disallowed these deductions stating "they do not represent ordinary and necessary business expense" and they "do not represent an allowable deduction." Since respondent determined that the reduction by Honolulu of its administrative expense by $100,000 was improper, he increased the deduction of Honolulu by $100,000 making a net disallowance of $325,000 of administrative expense for Honolulu and subsidiaries for their fiscal year ended June 30, 1959.

Whether Honolulu Had a Gain from Distributions in Liquidation by the Wherry Corporations
Issue 8

The amounts of the deposits with the United States District Courts in Texas and California withdrawn in August and September 1958 with respect to the various projects were as follows:

Corporation	Date of Withdrawal	Amount Withdrawn
Ord	August 27, 1958	$ 463,226.00
Monterey	August 27, 1958	318,827.00
Biggs	September 2, 1958	171,500.00
El Paso	September 2, 1958	166,500.00
	Total	$1,120,053.00

The cash was deposited in Honolulu's bank account and appropriate credit made on Honolulu's books to Foster who owned 15½ percent of the stock of each Wherry corporation and to his sons who together owned 5 1/6 percent.

Upon receipt of the cash, Honolulu entered on its books a credit of $888,576.13 to "Gain on Sale of Assets," which represented its 79 1/3 percent share of the total amounts withdrawn from the courts. As of June 30, 1959, Honolulu debited "Gain on Sale of Assets" by $888,576.13 and "credited intercompany amounts due to El Paso and Biggs of $134,073.45 each, and Ord and Monterey, $310,214.62 each." All the assets of each of the Wherry corporations were distributed to its shareholders on or before August 8, 1959.

The balance sheets attached to the Federal income tax returns filed by Ord, Monterey, Biggs, and El Paso for the taxable period February 11 through June 30, 1958, and the fiscal year ended June 30, 1959, shows deficits in earned surplus at the date and in the amounts as follows:

	February 10, 1958	June 30, 1958	June 30, 1959
Ord	$674,681.99	$675,894.96	$681,232.24
Monterey	602,121.27	603,856.64	611,068.55
Biggs	523,435.00	524,034.80	524,304.79
El Paso	555,469.45	555,870.76	555,824.48

The balance sheets attached to the Federal income tax returns of the Wherry corporations for the fiscal year ended June 30, 1959, show, in addition to mortgages payable which were with respect to the properties condemned by the United States, reserve for depreciation and capital surplus (which

was used by respondent to reduce the book bases of the leasehold assets condemned to eliminate increases made in the bases of those assets which increased bases were credited to capital surplus), only the following liabilities as of June 30, 1959:

	Accounts and notes payable	Accrued taxes	Sec. 337 gain	Capital stock class B
Ord	$101,353.71	None	None	$15,000
Monterey	31,687.15	None	None	15,000
Biggs	52,531.65	$25,986.88	$13,157.66	15,000
El Paso	81,800.00	25,983.41	1,598.38	15,000

The only difference in these liabilities and those shown as of June 30, 1958 was that accounts and notes payable were shown by these corporations as of the earlier date in the respective amounts of $95,394.54, $91,188.38, $103,729.52 and $101,577.04 and Biggs and El Paso showed no "Section 337 Gain."

Honolulu on its consolidated income tax return for the fiscal year ended June 30, 1959, did not report any gain from the receipt of its share of the amounts withdrawn from the courts in August and September 1958.

Respondent, in his notice of deficiency, determined that Honolulu received $888,576.13 from the Wherry corporations as distributions in liquidation during its fiscal year ended June 30, 1959 and that Honolulu's adjusted basis of the stock of these corporations was zero. Respondent, therefore, considered the entire $888,576.13 to represent a capital gain to Honolulu.

Transferee Liability
Issue 9

After withdrawal of deposits from the United States District Courts in California and Texas where the condemnation proceedings were pending, the Wherry corporations deposited in Honolulu's bank account the amounts of such withdrawals which were credited to the shareholders of the Wherry corporations by Honolulu as follows:

Credited to:	Amounts withdrawn from escrow account of Ord $463,226.00	Monterey $318,827.00	Biggs $171,500.00	El Paso $166,500.00	Total $1,120,053.00
Honolulu—79 1/3 percent	$367,492.63	$252,936.09	$136,056.67	$132,090.00	$ 888,575.39*
T. Jack Foster—15 1/2 percent	71,800.03	49,418.19	26,582.50	25,807.50	173,608.22
T. Jack Foster, Jr.—1 13/18 percent	7,977.78	5,490.90	2,953.61	2,867.50	19,289.79
John R. Foster—1 13/18 percent	7,977.78	5,490.91	2,953.61	2,867.50	19,289.80
Richard H. Foster—1 13/18 percent	7,977.78	5,490.91	2,953.61	2,867.50	19,289.80
	$463,226.00	$318,827.00	$171,500.00	$166,500.00	$1,120,053.00

*It is stipulated that Honolulu entered on its books the amount of $888,576.13 to represent its 79⅓ percent share of the amounts withdrawn from court. However, the sum of 79⅓ percent of each of the four amounts withdrawn is $888,575.39 (79⅓ percent of the total amount withdrawn ($1,120,053) is $888,575.38).

Honolulu received the Ord-Monterey and Biggs-El Paso cash distributions on August 27, and September 2, 1958, respectively. The individual shareholders received their credits for their portions of the distributions from all the Wherry corporations on September 5, 1958.

By August 8, 1959, all the assets of the Wherry corporations, including the claim of each such corporation against the United States Government in connection with the condemnation proceedings had been distributed to its shareholders. These claims of the Wherry corporations against the United States were satisfied at the times and in the amounts as follows:

	Date	Remaining just compensation — Principal	Interest
Ord Monterey	July 6, 1960	$ 412,128.94*	$ 55,684.20
Biggs El Paso	August 29, 1962	$1,362,000.00	403,920.57

*This figure represents three amounts:

Additional just compensation awarded by jury	$323,947.00
Agreed amount due for personal property	49,534.58
Mortgage insurance refund	38,647.36
	$412,128.94

Prior to the entry of the final order of the courts for payment to the Wherry corporations, the parties to the two condemnation proceedings had agreed at pretrial conferences that the two housing projects involved in each proceeding would be deemed one and that the final award would be one sum to be prorated by the respective corporations by agreement between them. Each corporation, or its distributees, received one-half of the final award in the proceeding to which it or they were a party, as follows:

	Principal	Interest	Total
Ord	$206,064.47	$ 27,842.10	$233,906.57
Monterey	206,064.47	27,842.10	233,906.57
Biggs	681,000.00	201,960.28	882,960.28
El Paso	681,000.00	201,960.29	882,960.29

Respondent determined that Honolulu, Foster, and Foster's three sons were liable as transferees of Ord, Monterey, Biggs and El Paso in the amounts set forth heretofore and by amendments to answer increased or reduced the amounts as determined in his notices of liability as heretofore set forth.

Ultimate Facts

Honolulu, Foster, and Foster's three sons are liable as transferees of the assets of the Wherry corporations for any Federal income taxes and interest thereon due by those corporations for the years here involved to the extent of the respective distributions from those corporations credited to them on September 5, 1958, from the distributions made by the Wherry corporations of amounts withdrawn in August and September 1958 from the deposits made by the United States with the courts in which the condemnation proceedings were pending plus the fair market value at the date of distribution of the claims of the Wherry corporations against the United States. Respondent has not shown that the fair market value at the date of distribution of the claims of the Wherry corporations against the United States, which claims were distributed by the Wherry corporations to their stockholders on or before August 8, 1959, exceeded the amount of $88,181.94 determined to be payable for mortgage insurance and escrowed funds and personal property of Ord and Monterey which represented distributions from Ord and Monterey in accordance with the amounts allocated to each in the stipulation agreement and court order with respect to those payments.

OPINION

Reallocation of Gain on Sale of Topeka Houses
Issue 1(a)

Section 482[6] authorizes the Commissioner to reallocate income or deductions among related organizations, if necessary, to prevent evasion of taxes or clearly to reflect income. Respondent's regulations provide that section 482 applies in the case of any controlled taxpayer, whether such taxpayer makes a separate return or a consolidated return. If a controlled taxpayer is a party to a consolidated return the "true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return."

Respondent takes the position that the sole purpose in the transfer by Topeka of the houses to Ord, Monterey, Biggs, and El Paso was to shift to those corporations income which otherwise would have been realized by Topeka in order that the corporations to which the houses were transferred might realize separate income against which to offset separate net operating loss carryovers part of which would expire if not used in the fiscal year ending June 30, 1957.

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6. SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Sec. 1.482-1(b)(2), Income Tax Regs.

* * * If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

Petitioners argue that there was a business purpose in Topeka's disposing of its houses and that the gain on Topeka's transfer of the houses to the Wherry corporations is properly eliminated as an intercompany transaction under Sec. 1,1502-31(b)(1)(i), Income Tax Regs.

Petitioner's argument does not answer the contention of respondent that the transfer of the houses from Topeka to the Wherry corporations had no purpose other than tax evasion.

Assuming that petitioners have shown a business purpose in Topeka's disposing of its houses, they have shown no business reason why the sales of these houses to persons outside the affiliated group should not have been made by Topeka instead of the Wherry corporations. It is unlikely that Topeka would have sold the houses to an unrelated purchaser for the price at which it transferred them to the Wherry corporations, since those corporations immediately sold the houses to unrelated parties at a substantial profit. However, even if it be assumed that the transfer value placed on the houses was a fair one, the fact that the transfer by Topeka to the Wherry corporations was an intercompany transfer on which gain is eliminated in filing a consolidated return would nevertheless permit evasion of tax by the transfer. Since there was available to the Wherry corporations separate net operating loss carryovers not available to Topeka, the fact that the entire profit on the sale of the houses to persons outside the affiliated group, as distinguished from only the portion of the profit above the amount used by Topeka as a transfer value, was income of the Wherry corporations enabled those corporations to handle the sales to outsiders in such a way as to make the separate income of each approximate the separate net operating loss carryover available to each.

As soon as the Wherry corporations had sold the houses and realized a gain which caused them to have separate incomes, the installment notes taken in part payment for the

properties were assigned to the common parent of Topeka and the Wherry corporations. In effect, Topeka made only a temporary transfer of the properties to the Wherry corporations to enable the Wherry corporations to use such properties temporarily to receive income to the extent of their separate net operating losses. The temporary transfer of an income-producing asset primarily for the purpose of avoiding tax by making use of a net operating loss of the transferee has been held to justify the reallocation of income and deductions under section 482. *Spicer Theatre, Inc. v. Commissioner,* 346 F.2d 704 (C. A. 6, 1965), affirming 44 T. C. 198, and *Ballentine Motor Co. v. Commissioner,* 321 F.2d 796 (C. A. 4, 1963), affirming 39 T. C. 348. The fact that Topeka transferred houses in unequal numbers to the Wherry corporations which sold them at amounts resulting in separate taxable income to each of approximately the amounts of the net operating loss carryover of each[7] gives a strong inference of a tax evasion purpose. Petitioners contend that the reason for the transfer was partly because the Wherry corporations were seeking financing for new projects in California and Texas and inclusion of the sales profits on their financial statements would improve their borrowing positions and partly because a high rate of default on the part of the ultimate purchasers of the houses was a possibility and the transfer of the houses by Topeka would insulate the group against deficiency judgments under Kansas law.

7.

	Loss carryover	Net income for fiscal year 1957	Collections on sales—1957
Ord	$ 81,875	$ 85,753	$ 95,314
Monterey	123,139	86,093	142,455
Biggs	106,418	106,344	110,098
El Paso	114,945	114,580	124,974

Without the benefit of the income from the sales of the Topeka houses they would have had no net taxable income.

Neither of these arguments is persuasive. There is nothing in the record to show that the Wherry corporations could not obtain financing for any projects they were contemplating developing despite their tax loss carryovers. These corporations had successfully constructed housing projects at two different military bases and during the years in issue derived the major portion of their income from rentals. Large depreciation deductions were claimed in each year, which resulted in income deficits for tax purposes but the indication from the record is that the market value of the assets of the Wherry corporations was substantially in excess of their liabilities so that each of the Wherry corporations had a substantial true net worth. Furthermore, the lack of any intent to improve the financial position of the Wherry corporations by the transfer of the houses to them may be inferred from the fact that the contract obligations received from the sales of the houses were transferred to Honolulu after the sales were complete and sufficient income realized by the Wherry corporations to permit use of their separate net operating loss carryovers.

Petitioners' argument that the transfer of the houses to the Wherry corporations would protect Topeka against loss on deficiency judgments, should the purchasers default, is also unpersuasive. The Wherry corporations did not assume any liability on the first mortgages, but Topeka was liable on them. Petitioners have made no showing of why a deficiency judgment could not be had against Topeka, even though Topeka had transferred the houses to the Wherry corporations. If Topeka was without assets after its transfer of the houses, such a situation could result only from the fact that Topeka received no consideration for the transfer of the houses or disposed of the consideration received by transfer to an affiliate without adequate consideration. If Topeka made a transfer of its assets for inadequate consideration, it would appear that a creditor of Topeka might

proceed against Topeka's transferees. Petitioners have certainly not shown otherwise.

We conclude from all the facts in the record that the primary purpose for the transfer by Topeka of the houses to the Wherry corporations prior to the sale of the houses to unrelated purchasers, was to enable the Wherry corporations to make use of their separate net operating loss carryovers and, thus, to avoid tax. Therefore, under the holdings in *Spicer Theatre, Inc. v. Commissioner, supra,* and *Ballentine Motor Co. v. Commissioner, supra,* respondent is within his authority under section 482 in reallocating gain on the sale of the houses to Topeka unless the fact that Topeka and the Wherry corporations all joined with their common parent, Honolulu, in filing consolidated income tax returns causes the holding in those cases to be inapplicable here.

The rationale of permitting the filing of a consolidated return by affiliated corporations is that a business, though fragmented in different legal units, may be a single economic entity and should be allowed the benefits for income tax purposes of a single economic entity. The rationale of the allowance of deductions of a net operating loss carryover is that the vicissitudes of a single business' "lean and fat" years may be averaged out to some extent. That affiliates filing a consolidated return are not viewed as a "single business" for the purpose of a net operating loss carryover from years before the consolidation or for any particular affiliate for years before it entered the consolidation is shown by the regulations[8] which provide for the use of net operating loss

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8. Sec. 1.1502-31(b)(3) *Limitation on net operating loss carryovers and carrybacks from separate return years.* In no case shall there be included in the consolidated net operating loss deduction for the taxable year as consolidated net operating loss carryovers or carrybacks under paragraphs * * * (relating to net operating losses sustained by a corporation in years for which separate returns were filed, or for which such corporation joined in a consolidated return filed by another affiliated group), an amount exceeding in the aggregate the taxable income of such corporation included in the compu-

carryovers from a year in which an affiliate filed a separate return only to the extent of the separate income of that affiliate included in the consolidated net income for the year to which the loss is being carried. Since the corporate petitioners agreed to accept these regulations,[9] in order to obtain the privilege of filing consolidated returns, the regulations control and allow the separate net operating loss carryovers of the Wherry corporations from years for which they filed separate returns to be used only to the extent of their incomes included in the consolidated return. Although affiliated corporations are permitted to file consolidated returns, they "are separate entities for the purpose of net operating loss deductions." *Fredro Corporation,* 36 T. C. 864, 877, (1961), reversed on another issue 315 F.2d 784 (C. A. 2, 1963). Where consolidated returns are filed and there is an attempt to carry a loss from a separate return year to a consolidated year (or to carry a loss from a consolidated year to a separate return year), the limitation that the loss of "one business" may not be used to average out the "income of some other business" is determined strictly under the regulations by considering each separate corpo-

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tation of the consolidated taxable income for the taxable year decreased by its deductions under sections 181, 243, 244, 245, 247 and 922 (and in the case of a member of an affiliated group to which the consolidated section 175 deduction is applicable, the section 175 deduction), increased by its separate net capital gain, and increased or decreased, as the case may be, with respect to its separate gains and losses from involuntary conversions subject to the provisions of section 1231, and from sales or exchanges of property subject to the provisions of section 1231 * * *

9. SEC. 1501. PRIVILEGE TO FILE CONSOLIDATED RETURNS.

An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return * * * The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. * * *

ration as a separate "business." *A. R. Ruppert Plumbing & Heating Co.*, 39 T. C. 284 (1962). Here, as in the *Ruppert Plumbing & Heating Co.* case, the facts "do not warrant a finding" that the businesses carried on by Topeka and the Wherry corporations were in substance "the same business." It is, therefore, unnecessary to consider whether if the business were in substance the same, respondent's regulations could be interpreted to permit the loss carryovers of the Wherry corporations to offset income of Topeka.

Since the separate loss carryovers of the Wherry corporations cannot be used to offset income of Topeka included in the consolidated income for the fiscal year ended June 30, 1957, it follows that "true consolidated taxable income of the affiliated group" and the "true separate taxable" incomes of Topeka and the Wherry corporations determined "consistently with the principles of a consolidated return" (Sec. 1.482-1(b)(2) Income Tax Regs.), requires that Topeka not be permitted in effect to shift its separate income for the fiscal year 1957 to the Wherry corporations.

We, therefore, sustain respondent's determination reallocating the gain on the sale of the houses which Topeka transferred to the Wherry corporations to Topeka under section 482.

Since we have sustained respondent's reallocation of income under section 482, it is unnecessary to consider his alternative contention that if the gain on the sale of the houses is properly that of the Wherry corporations for income tax purposes, it constitutes ordinary income and not capital gain.

Method of Applying Separate Net Operating Loss Carryovers
Issue 1(b)

The first difference between the parties with respect to proper application of separate loss carryovers of some of the

affiliated corporations to the separate incomes of those corporations concerns the fiscal years ended June 30, 1954 and 1955, in each of which the affiliated group had a consolidated net loss prior to application of net operating loss carryovers. The determination of the application of the loss carryovers in the fiscal years ended June 30, 1954 and 1955 is necessary in order to ascertain the amount of separate net operating loss carryovers of certain affiliates and the consolidated net operating loss carryover available for use in the fiscal year ended June 30, 1957, the first year in issue in this case, and subsequent years.

Petitioners take the position that the separate net operating loss carryover of a particular subsidiary that had separate net income could be used to apply against that subsidiary's separate net income, thereby increasing the overall net operating loss carryover of the sonsolidated group even though the consolidated group had a consolidated loss prior to application of any net operating loss carryover. Respondent contends that in years in which the consolidated group had a consolidated net loss prior to application of a net operating loss carryover, no separate net loss carryover of any affiliate may be used. This precise issue was involved in *Phinney v. Houston Oil Field Material Company,* 252 F.2d 357 (C. A. 5, 1958). That case was concerned with consolidated returns filed under Treasury Regulations issued under the Internal Revenue Code of 1939, but the section dealing with the carryover and carryback of separate net operating losses was substantially the same as section 1.1502-31(b)(3) of the regulations applicable to the years involved in the instant case.[10] In *Phinney v. Houston Oil Field Material Company, supra,* the Court held the consolidated net operating loss of an affiliated group could not be increased by first using the separate net operating loss of an affiliate which had separate income to offset the income of

10. Substantial changes have been made or proposed in consolidated regulations for years after 1965, but, of course, here we are not concerned with these changes.

the affiliate. In so holding the Court stated that to allow such an increase in the consolidated net operating loss would be contrary to the regulation which states that the "net income of an affiliate for consolidated return purposes shall be computed without benefit of a net operating loss deduction." Section 1.1502-31(b)(1)(ii), Income Tax Regs., applicable to the years here in issue in substance contains the same provisions, and Section 1.1502-31(a)(1) provides that the "consolidated taxable income shall be the combined income of the several affiliated corporations" minus "any consolidated net operating loss deduction."

We agree with the reasoning in the *Phinney* case. Unless there is consolidated net income prior to the use of any net operating loss carryover, there is no income of the consolidated group against which to apply a carryover and therefore no reason for application of a carryover. We therefore sustain respondent in his determination that the separate loss carryovers may not be applied against the separate incomes of the corporations having such separate carryovers in years in which there was a consolidated net operating loss prior to the application of any net operating loss carryovers.

The second problem as to the application of loss carryovers deals with the use of separate net operating loss carryovers in years when there was net income of the consolidated group prior to application of net operating loss carryovers. The only provision of the regulations with respect to this problem is that the amount of a separate net operating loss carryover which may be used shall not exceed the separate net income of the particular affiliate having the separate net operating loss carryover. However, the same reasoning applied in holding that no separate net operating loss carryover may be used in a year in which there is no consolidated net income prior to the use of any net operating loss carryover, leads to the conclusion that the amount of the consolidated net income prior to the use of any net operating loss carryover is the limitation on the total amount of net operating

loss carryover that may be used. As an example, on the basis of the returns as filed by petitioners which showed a consolidated net income for the fiscal year ended June 30, 1957, prior to the use of any net operating loss carryover, in the amount of $218,761.76, we would conclude that net operating loss carryovers in excess of this amount could not be used.[11] Having determined this limitation on the total amount of net operating loss carryover which may be used for the fiscal year ended June 30, 1957, it becomes nceessary to determine what portion of this total may constitute separate loss carryovers of affiliates with separate net incomes. We recognize that under respondent's regulations, these separate net operating loss carryovers are a part of the consolidated net operating loss carryover limited in use by the income of the affiliate using such separate carryovers. The theory of the regulations, as we have heretofore stated, appears to be that a loss generated by one business enterprise may not be used to offset income of another business enterprise. Absence this specific provision of the consolidated regulations to which the corporate petitioners agreed in order to be entitled to file consolidated returns, an inquiry might be required as to the similarity of the business enterprises of the various corporations in the consolidated group such as is involved in cases of mergers or other reorganizations. However, the regulation with respect to consolidated returns seems to require no such inquiry. In any event, it is not necessary in the instant case to consider the proper construction of respondent's regulations in this respect since there is no evidence in the record to warrant a finding that the various affiliated corporations were engaged in substantially the "same business" for net operating loss carryover purposes. See *A. R. Ruppert Plumbing & Heating Co., supra.*

11. Under our holding with respect to other issues, the amount of the consolidated net income prior to the use of any net operating loss carryovers will probably be changed from the income as reported by petitioners but we will use the reported income as illustrative of this issue.

Under respondent's regulations it sems logical to conclude that each subsidiary which has both separate income and a separate net operating loss carryover can use the separate loss carryover to the extent that its separate income contributed to the overall amount of consolidated net income from which is subtracted the total of the losses of all the affiliates reporting separate losses. In other words, the $218,861.76 consolidated net income reported by Honolulu and subsidiaries would be prorated to each affiliate reporting a separate income on the basis of applying to that amount the percentage that the income reported by that affiliate bore to the total of the separate incomes reported by all affiliates reporting separate incomes. If only those affiliates that had separate net operating loss carryovers also had separate net incomes, this would amount to prorating the consolidated net income among them. However, this is not the factual situation in this case. Some of the affiliates which had separate net incomes did not have separate net operating loss carryovers. However, it seems no more logical to indirectly increase the consolidated net operating loss carryovers by permitting the separate net operating loss carryovers of affiliates which have both such carryovers and separate incomes to be used to the full extent of the total consolidated net income of the group, thus freeing any consolidated net operating loss carryover from prior years which otherwise would be used to offset separate incomes of affiliates which reported separate incomes but had no separate net operating loss carryover, for use in subsequent years, than it is to directly increase the consolidated net operating loss carryover by permitting separate carryovers to be used by affiliates having separate incomes in years when there is a consolidated net loss.

We therefore hold that the amount of the consolidated net income, prior to application of any net operating loss carryover, is to be prorated among all affiliates reporting separate incomes whether or not such affiliate has a separate

net operating loss carryover on the basis that the income reported by such affiliates bears to the total of the income reported by all affiliates reporting income. The amount of income so allocated to each affiliate which has a separate net operating loss carryover, will be the maximum extent to which such separate net operating loss carryover may be used in computing the taxable consolidated net income.

In view of our holding that respondent correctly reallocated the income from the sales of certain houses from the Wherry corporations to Topeka, the issue with respect to the application of separate net operating loss carryovers will have substantially less effect on the consolidated tax liability for any of the years here in issue than would be the case had we not approved the respondent's reallocation of income to Topeka. However, since it appears that the method of applying the separate net operating loss carryovers will have some effect on the amount of the consolidated tax liability in each year here in issue, we consider it necessary to decide the issue.

Distributions by Ord and Highland Park in the Fiscal Year 1956
Issue 1(c)

Petitioners take the position that distributions made by Ord and Highland Park to Honolulu in the fiscal year 1956 were dividends and therefore under the provisions of section 1.1502-31(b)(2)(ii)[12] were excludable in computing consolidated net income. In the alternative, petitioners contend that if the amounts were not dividends, they should be eliminated from consolidated income under the provisions of section 1.1502-31(b)(1)(i) which provides for the elimination from consolidated income of "unrealized profits and losses

12. Sec. 1.1502-31(b)(2)(ii), Income Tax Regs.
(ii) Dividends received. In the computation of the dividends received, there shall be excluded all dividends received from other members of the affiliated group.

in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group." Petitioners argue that since the distributions were with respect to stock, they were dividends and therefore the "cost basis" of Honolulu in the stock is not a consideration in determining whether the amounts are includable in Honolulu's income.

The first problem therefore is whether the distributions made by Ord and Highland Park to Honolulu in the fiscal year 1956 constituted dividends. Respondent's consolidated regulations, section 1.1502, nowhere define "dividends". However, these regulations in section 1.1502-2(f), provide that "Terms which are defined in the Code shall, when used in the regulations under section 1502 have the meaning assigned to them by the Code, unless specifically otherwise defined." Therefore, in determining whether a distribution from a subsidiary to a parent of an affiliated group filing a consolidated return is a dividend, it is necessary to turn to the definition of dividend contained in section 316 of the Internal Revenue Code. Section 316 provides that the term "dividend" means any distribution of property made by a corporation to its shareholders out of its accumulated or current year's earnings or profits.[13]

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13. SEC. 316, I. R. C. 1954. DIVIDEND DEFINED.

(a) General Rule.—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

As we have set forth in our findings, Ord and Highland Park each had a loss for the fiscal year ended June 30, 1956 and the separate balance sheet of each of these corporations included with the consolidated return filed showed that each had an "earned deficit," as of the end of June 30, 1955 and June 30, 1956. From these facts we conclude that neither Ord nor Highland Park had any accumulated earnings or profits as of June 30, 1955 or June 30, 1956. Therefore under the definition contained in section 316 any distribution which they made to their stockholder fails to meet the definition of dividend and may not be considered as the distribution of a dividend.

It therefore becomes necessary to consider petitioners' alternative contention that the amounts of these distributions should be eliminated as "unrealized profits * * * in transactions between members of the affiliated group * * *." (Sec. 1.1502-31(b)(1)(i), Income Tax Regs.) The distributions made by Ord and Highland Park to Honolulu were made to Honolulu as the owner of their stock and were "distributions with respect to stock." Respondent determined to this effect and there are no facts to show to the contrary nor does petitioner contend to the contrary. Such facts as are in the record indicate that the distributions were with respect to stock.

The provision for the elimination of "profits" in transactions between members of an affiliated group is to be read in its normal context, and so read must be considered as referring to the exchange by one affiliate of money or other property for property, goods of, or services rendered by another affiliate. We therefore conclude that the nature of the distributions by Ord and Highland Park must be characterized as a distribution with respect to stock under the general definition of the terms in the Code. (Section 1.1502-2 (f), Income Tax Regulations).

Section 301(a) provides that the distribution of property, which is defined to include money as well as other property,

made by a corporation to a shareholder with respect to stock shall be treated in the manner provided in section 301(c).[14] Section 301(c) provides that the portion of the distribution which is a dividend shall be as defined in section 316 and that the portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock and that the portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property. Therefore, under the provisions of section 301(c)(3), the portion of the distribution by Ord and Highland Park to Honolulu in the fiscal year 1956 that exceeded the basis of Honolulu in the stock of Ord and Highland Park, shall be treated as gain from the sale or exchange of property. This conclusion is in accordance with our holding in *American Water Works Co.*, 25 T. C. 903 (1956), affirmed on this issue and reversed on another issue 243 F.2d 550 (C. A. 2, 1957). In that case we held that the basis of the stock of an affiliate should be reduced by distributions made by that affiliate not out of earnings and profits during the years when consolidated returns were filed. In so holding we relied on a provision of respondent's regulations that the basis of stock of the issuing corporation held by each member of the

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14. SEC. 301(c) Amount Taxable.—In the case of a distribution to which subsection (a) applies—

(1) Amount constituting dividend.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount applied against basis.—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in excess of basis.—

(A) In general.—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) Distributions out of increase in value accrued before March 1, 1913.—That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

affiliated group other than the issuing corporation should be separately determined for each member of the group and adjusted in accordance with "the Code" in order to determine gain or loss on the sale of such stock. In *American Water Works Co., supra,* we stated, at page 912, the following:

> The petitioner argues that there should be no reduction in the basis of its stock in Texarkana due to the capital distributions made to it by Texarkana in years when consolidated income tax returns were filed by the two corporations. No support for the petitioner's argument can be found in section 23.31(d)(2) of Regulations 104. This section states that capital gains and losses on a consolidated return shall be determined without regard to "gains or losses arising in intercompany transactions." Such a transaction is not before us. We have in this case a sale of stock by the petitioner to a party outside the affiliated group, and any gain arising from such sale cannot be regarded as arising in an intercompany transaction. * * *

In the instant case we are concerned with the provisions of section 1.1502-31(b)(2)(iii)(a) of respondent's regulations provided that capital gains on transactions between members of an affiliated group shall be eliminated in determining consolidated taxable income.[15]

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15. SEC. 1.1502-31(b). Computations. In the case of affiliated corporations which make, or are required to make, a consolidated return, and except as otherwise provided in the regulations under section 1502:

(1) Taxable income. The taxable income of each corporation shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations, except:

(2) Other computations on separate basis. The various other computations required by the regulations under section 1502 to be made by the several affiliated corporations shall be made in the case of each such corporation in the same manner and under the same

Since, as we have stated, the distributions by Ord and Highland Park to Honolulu are to be treated under section 301(c) as "gain from the sale or exchange of property," the gain would be a capital gain. Since the distribution was by the subsidiary to its parent, the gain arises in an "intercompany transaction." Therefore, the specific language of respondent's regulations provides that in the computation of the incomes of the various members of the affiliated group, of which, of course, Honolulu is one here, to be used in determining the consolidated net income or loss, the determination shall be made without regard to the gain arising in this transaction. The transaction is not within either of the exceptions contained in respondent's regulations.

Respondent, in his brief, makes no argument as such against the application of section 1.1502-31(b)(2)(iii)(a) but merely cites and relies on *Revenue Ruling* 57-201, 1957-1 *C. B.* 295. In this ruling respondent states as his position that the gain accruing to a parent corporation from cancellation of its indebtedness to a subsidiary is recognized in computing consolidated income to the extent that the advances from the subsidiary exceed the basis of the subsidiary's stock in the hands of the parent. Under the provisions of section 301(c), such excess is taxable in the same manner as gain from the sale or exchange of property and constitutes capital gain. In justification for ignoring the provisions of section 1.1502-31(b)(2)(iii)(a) of his regulations, respondent states as follows in his ruling:

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conditions as if a separate return were to be filed, but with the following exceptions:

* * *

(iii) Capital gains and losses. Capital gains and losses, short-term capital gains and losses, long-term capital gains and losses, and the additional capital loss deduction authorized by section 832(c)(5) shall be determined without regard to:

(a) Gains or losses arising in intercompany transactions (other than gains described in section 357(c) and gains recognized to the distributing corporation pursuant to section 311(c) by reason of distributions by one member of the group to another member of the group.

* * *

The general design of the consolidated return regulations permits transfers of property between members of an affiliated group which files a consolidated return to be made without present tax consequences if no ultimate tax advantage is gained thereby. Thus, section 1.1502-31(b)(2)(iii)(a) of the Income Tax Regulations provides, in effect, that capital gains on sales or exchanges between members of an affiliated group shall be eliminated in determining consolidated taxable income. The possibility that this rule could lead to tax avoidance is obviated by section 1.1502-38(b) of the Income Tax Regulations which provides that the basis of property in the hands of one member of an affiliated group shall remain the same when it is transferred to another member of the group. Thus, the gain remains potentially taxable after the transfer of property and is recognized if the property is then sold outside of the affiated group.

However, this safeguard would not be present if the gain which results from the distribution in the instant case were eliminated in computing consolidated taxable income. Since no property other than cash is transferred, there is, of course, no carry-over of basis; and, although the distribution reduces the basis of the subsidiary's stock in the hands of the parent to zero, there is no adjustment to reflect the amount of distribution in excess of the basis of such stock. If the parent sold the stock at a later date, any gain then recognized for income tax purposes would be less than the actual gain on its investment in the subsidiary.

Thus, if gain were not recognized upon the distribution, the excess of the distribution over P's basis of the stock would completely escape taxation, contrary to the express purpose of Congress and the design of the regulations. Compare section 1.1502-37(a)(1)(ii) of the Regulations which provides for the inclusion of gain on

> the receipt of certain cash distributions from a member of an affiliated group in cancellation or redemption of its stock. * * *

The substance of respondent's statement in this ruling is that something specifically provided to the contrary in his regulations shall be used in the computation of consolidated income since otherwise there is a possibility of certain income escaping tax. Under similar circumstances, we specifically refused to follow a ruling by respondent in *Henry C. Beck Builders, Inc.*, 41 T. C. 616, 628 (1964). In so doing we stated:

> Respondent has broad power to amend his regulations. He must have known of this "loophole" before the deficiency notice was sent in this case. *Revenue Ruling* 60-245, 1960-2 *C. B.* 267, involving an almost identical set of facts, appeared 2 months before the date of the notice. Respondent there cited no provision of the Code or regulations to support his view that the parent should be taxed on the previously eliminated profit when the parent disposed of the subsidiary's stock. [footnote omitted] Respondent's reluctance to use his conceded power in this area to set forth rules of general application * * * does not justify in this case a judicial improvisation to prevent a reduction of the revenue that is problematic in both nature and amount. [footnote omitted]

The same statement is equally applicable to the situation here involved. It is problematical whether the amount distributed to Honolulu by Ord and Highland Park has not in effect been a part of the consolidated income which has been subject to tax. Here it would appear that the situation is as in respondent's revenue ruling 57-201, *supra*, that the "corporation receives rental income from property that it owns, but, principally due to the deduction for depreciation, it has

no taxable income or earnings and profits for tax purposes." However, except for the income from which the depreciation was deducted, Ord and Highland Park would be unlikely to have available an amount to distribute in cash to Honolulu. Had the corporations not had and reported this income, their losses would undoubtedly have been greater and the reduction in tax which might have resulted from such increased losses is quite "problematic."

Expressed another way, to the extent that the cash which was distributed to the parent was accumulated by the subsidiaries during consolidated years, it very likely has in some way been taxed as an overall part of the consolidation. The fact that respondent in connection with redemption of stock issued a specific regulation which we will subsequently discuss, does not justify reaching a conclusion specifically contrary to another portion of his regulations where he has not chosen to change those regulations.

In affirming in part our decision in *American Water Works Co., supra,* the Circuit Court stated with regard to the provision of the regulations there under consideration comparable to section 1.1502-31(b)(2)(iii)(a) of the present regulations (243 F.2d 550, 554):

> * * * Thus taxpayer fails to distinguish between (1) the treatment of capital distributions from the issuing corporation to the stockholder corporation for *the purpose of computing their consolidated net income in the year of the intercompany distribution,* and (2) the treatment of these same capital distributions for *the purpose of determining the basis of the stock of the issuing corporation in the hands of the stockholder corporation when that stock is subsequently sold to an outsider.*

Even though the Circuit Court proceeded to discuss the fact that Congress did not intend such a "windfall" as would result to the taxpayer there involved if the basis of the stock were not reduced by prior distribution, there is nothing to

indicate that the Court intended to hold that respondent's regulations specifically providing for elimination of capital gain from transactions between members of the affiliated group should not control in a situation such as we have in the instant case. The Court in its opinion referred to the Treasury regulations in connection with consolidated returns as having "in effect, the force of law."

We therefore hold that the distributions made by Ord and Highland Park in 1956 are properly used to reduce petitioners' bases in the Ord and Highland Park stock, but to the extent that the distributions exceed Honolulu's basis in the stock they are to be treated as capital gains in transactions between members of the consolidated group and the computation of the consolidated net income or loss for the year 1956, for the purpose of determining the net operating loss carryover to the fiscal year ended June 30, 1957, is to be made by determining Honolulu's income without regard to this capital gain.

Gain on the Redemption of the Ord and Monterey Stock
Issue 2

After obtaining permission from the FHA in accordance with a requirement applicable to Wherry corporations, Ord and Monterey, in the fiscal year ended June 30, 1957, redeemed all of their class A stock held by Honolulu. Respondent determined that Honolulu received long-term capital gain on this redemption which should be included as such in computing consolidated taxable income of Honolulu and its subsidiaries. It is respondent's position that this determination is strictly in accordance with the provisions of section 1.1502-37(a)(1)(i) and (ii), Income Tax Regs.,[16] which

16. Sec. 1.1502-37 Liquidations; recognition of gain or loss.
(a) *During consolidated return period.* (1) Gain or loss shall not be recognized upon a distribution during a consolidated return period, by a member of an affiliated group to another member of

provides an exception to the non-recognition of gain or loss upon a distribution during a consolidated return period by one member of an affiliated group to another member where the distribution is in cancellation or redemption of all or a portion of the stock of the affiliate making the distribution. The exception to which respondent refers is where a distribution is one made in cash in an amount in excess of the adjusted basis of the stock.

Petitioners argue that this regulation applies only to distributions in liquidation which the instant distribution in redemption of the class A stock was not. We do not agree with petitioners' interpretation of the regulation since we think the clear import of this regulation is that section 1.1502-37(a)(1)(i) is applicable in case of a complete liquidation and redemption of all stock where the corporation terminates its business, and section 1.1502-37(a)(1)(ii) provides for a situation where there is a redemption of all or a portion of the stock without such a liquidation and termination of business being required. Technically, since the two are in separate paragraphs and precede a third paragraph, (iii), which follows the word "or" this is the logical interpretation. Also, we interpreted this provision in *Henry C. Beck Builders, Inc., supra,* at page 631, to apply to a redemption not in complete liquidation. Petitioners' reliance on section

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such group, in cancellation or redemption of all or any portion of its stock, except—

(i) Where such distribution is in complete liquidation and redemption of all of its stock (whether in one distribution or a series) and of its bonds and other indebtelness, if any, and falls without the provisions of section 332, and is the result of a bona fide termination of the business and operations of such member of the group, in which case the adjustments specified in §§ 1.1502-34 and 1.1502-35 shall be made, and § 1.1502-36 shall be applicable:

(ii) Where such a distribution without the provisions of section 332 is one made in cash in an amount in excess of the adjusted basis of the stock, and bonds and other indebtedness, in which case gain shall be recognized to the extent of such excess; or

* * *

1.1502-33[17] is misplaced since that section specifically provides for the taxability of gain or loss on disposition of stock in intercompany transactions except where the disposition is by sale or in complete or partial liquidation not involving cash in excess of the adjusted basis of the stock.

In the instant case the disposition of Ord and Monterey stock was by redemption of the class A stock and not by sale or by complete liquidation and there was cash in excess of basis involved. We therefore sustain respondent in his determination that to the extent the amounts paid by Ord and Monterey to Honolulu in redemption of their class A stock exceeded Honolulu's basis in that stock, Honolulu realized capital gain includable in consolidated net income.

Petitioners next argue that the redemption price was less than Honolulu's basis in the stock. The answer to this contention is governed by whether respondent properly reduced the basis of the Ord stock to zero because of the distribution to Honolulu in 1956 and the basis of the Monterey stock by the $36,000 distribution Monterey made to Honolulu in 1956.

The issue here is precisely the same as that involved in *American Water Works Co., supra,* and on the basis of that case we hold that respondent did properly reduce the basis

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17. Sec. 1.1502-33 Gain or loss from sale of stock, or bonds or other obligations.

Gain or loss from the sale or other disposition (whether or not during a consolidated return period), by a corporation which during any period of time has been a member of an affiliated group which makes or is required to make a consolidated return, of any share of stock or any bond or other obligation issued or incurred by another corporation which during any part of such period was a member of the same group, shall be determined, and the extent to which such gain or loss shall be recognized and shall be taken into account shall also be determined, in the same manner, to the same extent, and upon the same conditions as though such corporations had never been affiliated except—

(a) In the case of a disposition (by sale, or in complete or partial liquidation not involving cash in an amount in excess of the adjusted basis of both the stock and the bonds and other indebtedness liquidated, or otherwise) during a consolidated return period to another member of the group (§§ 1.1502-31 and 1.1502-37);

* * *

of the Ord and Monterey stock because of the 1956 distributions. As we pointed out previously, these corporations had no earnings or profits for the current year or accumulated earnings or profits so the distributions were not out of earnings or profits, and therefore reduced the basis of the stock.

By amendment to answer, respondent alleged that the remaining basis of the Monterey stock should be reduced to reflect losses which could not have been used by Monterey if Monterey had filed separate returns during the years of consolidation. Sections 1.1502-33 and 1.1502-37 both require that the basis for determining gain or loss on the disposition of stock of an affiliated member of a consolidated group which makes or is required to make a consolidated return shall be adjusted in accordance with section 1.1502-34 of respondent's regulations. This section of the regulations carries a specific provision that the basis of the stock is to be reduced by the sum of "all losses of such issuing corporation sustained during taxable years for which consolidated income tax returns were made * * * to the extent that such losses could not have been availed of by such corporation as net loss or net operating loss in computing its net income or taxable income * * * for such taxable year if it had made a separate return for each of such years." Sec. 1.1502-34(b)(2)(i), Income Tax Regs.

Respondent therefore is correct that the basis of the stock is to be reduced by losses of Monterey availed of in the computation of consolidated net income which could not have been availed of had Monterey filed a separate return. Petitioners on brief do not argue the point with respect to the further reduction of the Monterey stock, and respondent's computation of the $95,330.54 loss which was availed of which could not have been used had Monterey filed a separate return appears to be a minimum required reduction

under the regulations.[18] Respondent made the computation on the assumption that under the provisions of section 1.1502-34(b)(2), a reduction was required of the loss of Monterey for the fiscal years ended June 30, 1954 and 1955, because the consolidated group sustained a consolidated loss "not availed of in prior or subsequent years as a deduction under net loss or net operating loss provisions."

This may or may not be the situation after recomputation in accordance with our decision in this case since the results of a recomputation under our decision on all the issues may be that all consolidated losses for the fiscal years ended June 30, 1954 and June 30, 1955, would be availed of by a consolidated group in a subsequent year. However, the computation as made by respondent reduces the amount of the loss of Monterey which could not have been availed of had Monterey filed a separate return. If this adjustment were not made, the result would be a greater and not a lesser reduction of the basis of Monterey stock. Therefore, since respondent made the contention by an affirmative allegation in an amendment to answer, the total amount of reduction applicable to all classes of Monterey stock is the $95,330.54 which he has claimed and alleged even though as a result of the recomputation in this case a higher amount might otherwise appear to be a proper amount.

This brings us to the next question of whether respondent has properly distributed the reduction between the class

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18. Respondent's computation is as follows:

Fiscal year ended June 30	Taxable income		Extent separately available to Monterey as net loss deduction	Reduction of adjustment due to consolidated loss	Adjustr under 1.1502 (b)(2 Incor Tax Re
	Monterey	Consolidated			
1954	($ 23,877.39)	($224,615.30)	0	$23,729.03*	($ 14
1955	(78,663.99)	(248,820.96)	0	55,572.06*	(23,09
1956	(72,090.25)	449,799.81	0	0	(72,09
	($174,631.63)			$79,301.09	($95,33

* $\frac{\text{Monterey's loss}}{\text{Total losses of all corporations having losses}} \times \text{Consolidated loss}$

A stock of Monterey redeemed and the class B stock which was not redeemed. Section 1.1502-34(b)(4), Income Tax Regs., provides for this distribution. Respondent in making the computation, assigned a basis of $200,000 to the class A stock redeemed and $15,000 to the class B stock not redeemed. However, the stipulated facts are that the basis of Honolulu in the class A stock of Monterey was $215,000 and the only evidence in the record as to the basis of the class B stock is the statement on the balance sheet of Monterey showing as a liability class B capital stock in the amount of $15,000. Since this is an affirmative allegation on the part of respondent, he must prove all the necessary facts to make the determination. It may be that the class B stock did not have a basis of $15,000 in addition to the $215,000 basis stipulated to be that of the class A stock, but respondent has failed to show that this is a fact and therefore we hold that in prorating the reduction in basis to the various classes of stock the value of the class A stock to be used is $215,000 and the value of the class B stock is $15,000.

Our holding with respect to the requirement for a reduction in the basis of the stock redeemed for losses of Monterey during the consolidated period which that corporation could not have availed itself of if it had filed a separate return is in accordance with our holding on a similar issue in *Henry C. Beck Builders, Inc., supra.*

Deduction of Legal and Appraisal Fees
Issue 3

The first of the items which respondent disallowed as a deduction was the amount of $2,700 paid by Ord and Monterey for legal services to secure permission to redeem their stock held by Honolulu. This amount was paid during the fiscal year ended June 30, 1957. There is no question that it was not a necessary payment since the FHA required obtaining permission to redeem the stock.

The facts show that the redeemed stock was cancelled. The redemption involved all of the class A stock of Ord and

Monterey and none of the class B stock. Petitioners make no argument as to the legal nature of the expenditure in connection with the redemption of the stock. Respondent, in his brief, argues that the expenditure should be added to the cost of "Treasury stock acquired by the corporation." However, the facts show that the redeemed stock was cancelled and therefore there is no "treasury stock" acquired by the corporation to add this expense to as a basis.

We agree with respondent that the item is of the nature of selling expenses in connection with the sale of stock. Ordinarily, this would be considered as increasing the amount paid for the stock and would become a part of the cost and basis of an asset acquired. In the instant case, Ord and Monterey redeemed their stock and so had no asset, the basis of which could be increased. Under these circumstances the amount is in the nature of an amount expended in an effort to acquire a capital asset which results in a failure to acquire the asset. On this analogy we conclude that petitioners are entitled to deduct the $2,700 payment.

The next item involved in respondent's disallowance of legal and appraisal fees is an amount of $17,500 which is a portion of the $20,000 paid in 1958 to the attorney who generally handled the legal affairs of the Foster corporations and partnership. The services were rendered during the fiscal year ended June 30, 1956, and all the evidence shows with respect to these services is that the law firm to which the fee was paid had been counsel to the Foster organization since 1950 and that the fee did not relate to services performed with respect to the condemnations of the properties of the Wherry corporations. The bill for the fee showed that it was for services rendered to all Foster companies during the year 1956.

The only problem here is whether there is any justification for allocating the sum of $17,500 to Honolulu and its subsidiaries leaving only $2,500 as applicable to the partnership or any other work that might have been done for Foster which was not in connection with Honolulu and its subsidiaries.

The only evidence with respect to this allocation is the testimony of Foster that an effort to properly allocate items was made. He could not remember precisely what the fee was for, nor how the amount was allocated. A difficult problem is posed here since the burden of proof rests on petitioners to show that the $17,500 was a proper deduction for Honolulu and its subsidiaries. Although the proof is meager, we are satisfied that the entire $20,000 was a proper business expense deduction and that to the extent of the $17,500 it has not been taken as a deduction by any of the other Foster interests. We also give some weight to the fact that there does not appear to be any particular tax benefit in the method used to allocate the fee and for this reason it is unlikely that the allocation was made otherwise than in accordance with the best judgment of the employees of the Foster interests charged with the responsibility of the company's books as to the portion of the legal services rendered to the various Foster interests. We therefore hold that Honolulu and its subsidiaries are entitled to the deduction of the $17,500 as a business expense.

Respondent argues that since the legal fees were for services rendered in the fiscal year 1956, the amount of such fee should have been accrued by Honolulu and subsidiaries in that year and deducted in computing the income for that year and not deducted in the fiscal year ended June 30, 1958, when the amount was paid. The evidence here shows that there was no agreement between Honolulu and its subsidiaries and the attorneys as to the amount of the legal fee and that the amount of the fee for the services was not reasonably ascertainable by Foster or any of the Foster employees or by Honolulu or its subsidiaries until the receipt of the bill. Therefore, even if we assume that the corporate petitioners were on an accrual basis of accounting, the legal fees were not accruable prior to 1958 when the bill for services was received. *Lanova Corporation,* 17 T. C. 1178, 1186 (1952). We therefore agree with petitioners that the $17,500 was properly deductible in the fiscal year ended June 30, 1958.

The remaining items in issue, if petitioners are still contesting these adjustments, are $500 of an amount paid for a legal opinion with respect to procedure in the condemnation proceedings and a $5,000 legal fee and $9,000 appraisal fee paid with respect to these condemnation proceedings. It is not clear whether petitioners now concede that these adjustments are proper. In any event, the evidence shows that these items were expenses in connection with the disposition of the properties of the Wherry corporations in the general nature of selling expenses. Respondent has allowed these items as expenses in computing the gain in connection with the condemnation. Respondent's adjustment in this respect is correct, and we sustain respondent in his disallowance of these amounts as deductions for business expenses and hold he was correct in considering the amounts to be a reduction of the amount received on the disposition by condemnation of the properties of the Wherry corporations.

Deductibility of Expenses in Connection with Acquisition of Property

Issue 4

Respondent disallowed a total amount of $120,811.04 claimed as a deduction by Lomita for the fiscal year ended June 30, 1957, and treated the amount as a part of the basis in the properties acquired by Lomita which it subsequently sold. Two of the items involved in the total of $120,811.04 disallowed by respondent are $66,257.30 and $14,687.32 of bank charges in the nature of interest expense which had been incurred by California Development Company before the San Jose property which was being developed by that company was transferred to Lomita.

It is well settled that expenses of a preceding owner of property paid by the person acquiring such property, irrespective of what would be the nature of the expenses to the prior owner, are a part of the cost of acquiring the property by the person so acquiring the property and become a part

of the basis or purchase price of the assets acquired. Such payments are capital expenditures and not current expenses or losses to the individual who acquires the property. *Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (C. A. 8, 1946), affirming a Memorandum Opinion of this Court.

One of the remaining items composing the $120,811.04 was an amount of $1,650.62 which represented costs to Lomita of engineering fees for plans for the development. This item is one of a capital nature and petitioners make no real argument to the contrary.

The final item composing the amount disallowed as a deduction and capitalized by respondent is an amount of $38,215.80. The precise nature of this amount is not clear. The stipulation states with respect to this item, "Subsequent to the date of default, Lomita expended for FHA and FNMA commitments the sum of $38,215.80 * * *." If the amount had been paid by Lomita for its own commitments it would appear that it would be of the same nature as the engineering fees and a capital expenditure. However, the testimony shows that the $38,215.80 was a commitment fee with respect to the loan to California Development Company and that this amount of the commitment fee was applicable to loans which had not been drawn down. The $38,215.80 was apparently a part of the loan assumed by Lomita. If this item was an expense of the previous owner of the property which was assumed and paid by the person to whom the property was transferred, it, like the interest expenses, is properly to be capitalized. *Holdcroft Transp. Co. v. Commissioner, supra.*

The state of evidence in this case does not justify a conclusion that the $38,215.80 was something other than part of the cost of the property to Lomita. The burden of proof with respect to the deduction of the expenses rests on petitioners and petitioners have failed to show that this item is one that is properly deductible. We therefore sustain respondent's determination that the entire $120,811.04 is not deductible as business expense but is an additional cost of the San Jose property acquired by Lomita.

Claimed Deductions for Travel and Entertainment Expense

Issue 5

The various travel and entertainment expenses disallowed by respondent to Honolulu and subsidiaries in the computation of consolidated income fall basically into two categories. The first is composed of $4,100 of deductions claimed by the Wherry corporations. Of this amount respondent considered $1,500 to be expenses in connection with the condemnation of the property of Wherry corporations and increased the sales expense of those projects by that amount in determining the gain on the condemnation of the property.

The testimony shows that the Wherry corporations incurred some expenses in connection with repairing certain fixtures in the various houses in the projects and in inventorying certain personal property belonging to the corporations and inspecting the units to determine their condition prior to their condemnation. Since the personal property as well as the leasehold was condemned, the expenses in connection with repairing fixtures to increase their value at the time of condemnation are properly to be considered as a reduction in the price received for the property when sold. The other items for which the expenditures were made are likewise in the nature of selling expenses of the properties. Expenses connected with a condemnation of property are, as those connected with a sale of property by other methods, capital expenditures, which are deductible from the amount received for the property in computing the gain on its sale. *William Justin Petit,* 8 T. C. 228, 236-237 (1947).

Petitioners have the burden of proving that the expenses incurred by the Wherry corporations in preparing the properties for condemnation were greater than the $1,500 allowed by respondent. This burden petitioners have not sustained.

Foster testified with respect to going to the project and carrying cash and paying for certain items in cash but he did not testify as to the amounts so expended. The evidence

is wholly insufficient to justify a conclusion that the amount of the expenditure was greater than the amount allowed by respondent.

The remaining controversy involves an amount of $4,344 claimed as a deduction by Honolulu, the nature of which is unexplained in the evidence and an amount of $10,000 claimed as a deduction by Honolulu which represented an allocable portion of an amount of $20,301.50 of travel and entertainment expenses paid by the Foster partnership. The evidence does not show the nature of the travel and entertainment expenses paid by Foster & Sons which comprise the $20,301.50.

We might attempt to determine whether any portion of the amounts paid as travel and entertainment expenses by Foster & Sons was properly chargeable to Honolulu if we knew the nature of these expenses. There is no evidence in the record as to the nature of the expenses. We are not warranted in considering that any portion of the $10,000 deduction claimed by Honolulu for such expenses was proper without any information as to the items that comprise the total expenses of which $10,000 was allocated to Honolulu. It is possible that of the total of $20,301.50 an amount of $10,000 was not such entertainment expenses as to constitute an ordinary and necessary business expense deduction for any of the Foster organizations. Since the burden of proof with respect to deductions claimed is on petitioners, we sustain respondent in his disallowance of the claimed deductions for travel and entertainment expense in the amount of the $4,344 for the fiscal year 1958 and $10,000 for the fiscal year 1959.

Gain with Respect to the Condemnation of the Property of the Wherry Corporations

Issue 6

That there was ultimately a gain from the condemnation of the properties owned by the Wherry corporations is clear from the facts and petitioners do not argue to the contrary. However, the time that such gain arose has a substantial

effect on the tax liabilities of the various corporate petitioners because of the plan of liquidation adopted by the four Wherry corporations in August 1958 and the completion in August 1959 of that liquidation within a year after the plan was adopted. It is also necessary to determine whether any gain was realized prior to February 10, 1958. On that date the Wherry corporations ceased to be affiliates of Honolulu and therefore income received prior to February 10, 1958, is a part of the consolidated income for Honolulu and subsidiaries for the fiscal year ended June 30, 1958, while income received by the Wherry corporations after February 10, 1958, is taxable to them as separate corporations, and the resultant tax is a part of the liability of their stockholders as transferees to the extent of the value of the assets transferred to the stockholders.

The facts which we have set forth show that each of the Wherry corporations had a principal balance due on its mortgage in excess of its adjusted basis in the properties condemned at the dates in 1957 when the United States filed the condemnation proceedings and notices of taking. If the filing of these suits in which each of the Wherry corporations shortly thereafter filed a notice of appearance in which no objection was made to the taking of the property, but only a demand for a jury trial as to just compensation, constituted a sale or other disposition of the properties whereby the Wherry corporations were relieved of their mortgage indebtedness, respondent is correct in his determination that each of the Wherry corporations received gain on the disposition of a capital asset to a person outside the affiliated group prior to February 10, 1958, and the capital gain so received is a part of the consolidated net income of the group for the fiscal year ended June 30, 1958.

Where property is sold subject to a mortgage liability the amount received by the seller includes the amount of the mortgage to which the property was subject, even though the mortgage is not assumed by the purchaser. *Crane v. Com-*

missioner, 331 U. S. 1 (1947). In accordance with this principle, had the properties been sold by the Wherry corporations to the United States, those corporations would have realized income to the extent that the mortgages to which the properties were subjected exceeded their bases in the properties even though the amount which they would obtain in excess of such mortgages could not be considered as sufficiently ascertained to determine the entire gain ultimately to be received. If the properties had been sold subject to the mortgages for only $1, the entire bases of the Wherry corporations in the properties would have been returned to them and the excess of the mortgage indebtedness subject to which the properties were sold, would result in income to them, since in each instance "the 'amount realized' on the sale" included the amounts outstanding on the mortgages. *Crane v. Commissioner, supra.*

Petitioners, however, argue that the condemnation proceedings under which the properties of the Wherry corporations were taken are more comparable to an involuntary conversion. Petitioners state that the liabilities of the Wherry corporations on the mortgages were unaffected by the transfer and all that the Wherry corporations received was a right to an award against which the mortgages might ultimately be offset.

When the facts which we have set forth are considered in connection with the statutes under which the condemnations were made, petitioners' analysis is not supported by the evidence. Section 1594a(c)(2) of Title 42 of the United States Code which is a portion of the governing statute which authorized the acquisition by the United States of housing financed under the Wherry Act, provides that in order to have possession of the houses surrendered under a declaration of taking, the minimum deposit necessary to be made shall be an amount equal to the actual cost of the housing as certified by the sponsor or owner of the project to the FHA, reduced by the amount of the principal obligation of the

mortgage on the project remaining outstanding.[19] Therefore, in order for the United States to obtain possession of the properties, which the facts show it did in 1957, it was necessary for the United States to guarantee that the amount to be paid for the project would be at least in the principal amount of the FHA mortgages outstanding.

Any reasonable interpretation of this statute and of the pleadings in the condemnation case and the judgment of the District Court that title to properties was in the United States is that petitioners were relieved of their mortgages upon the transfer of title to the properties to the United States "subject to the interest of" the mortgagees. All of these events occurred before the end of the calendar year 1957.[20]

Therefore, unless it is to be considered that in a condemnation, as distinguished from a sale, the amount of the mort-

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19. 42 U.S.C. 1594a(c)(2) provides in part as follows:

In any condemnation proceedings instituted to acquire any such housing, or interest therein, the court shall not order the party in possession to surrender possession in advance of final judgment unless a declaration of taking has been filed, and a deposit of the amount estimated to be just compensation has been made, under section 258a of Title 40. The amount of such deposit for the purpose of this section shall not in any case be less than an amount equal to the actual cost of the housing (not including the value of any improvements installed or constructed with appropriated funds) as certified by the sponsor or owner of the project to the Federal Housing Commissioner pursuant to any statute or any regulation issued by the Federal Housing Commissioner, reduced by the amount of the principal obligation of the mortgage outstanding at the time possession is surrendered, but any such deposit shall not include any excess mortgage proceeds or "windfalls", kickbacks and rebates received in connection with the construction of said housing as determined by the Department of Defense, or any other Federal agency. * * *

20. This identical question was passed upon by this Court in *Moses Lake Homes, Inc.*, T. C. Memo. 1964-289. There we held that, "It is nevertheless clear that as a result of the involuntary disposition of their leasehold interest, the petitioners on March 1, 1958, realized the amount of the total mortgages outstanding, subject to which their leasehold estates on that date were transferred to the United States Air Force. *Crane v. Commissioner*, 331 U.S. 1; *Parker v. Delaney*, 186 F.2d 455; *Wala Garage v. United States*, 163 F. Supp. 379."

gage is not a part of the "amount realized," then the Wherry corporations realized gain because of the excess of the mortgage liabilities on the properties transferred to the United States over their bases in the properties while they were affiliated and filing a consolidated return with Honolulu.

In *Hawaiian Gas Products v. Commissioner,* 126 F.2d 4 (C. A. 9, 1942), affirming 43 B. T. A. 655 (1941), it was held that condemnation proceedings amounted to a sale for the purpose of the provisions relating to gains and losses on the sale of a capital asset and that the sale occurred at the time of the transfer of the property. The transfer of the property is when it passes at the time of taking determined under the law under which the condemnation occurs. *Kieselbach v. Commissioner,* 317 U. S. 399 (1943).

Under the law under which this condemnation proceeding was instituted the taking occurred upon the filing of the declaration and the deposit of some amount in excess of the mortgage liability on the property.

Since we sustain respondent in his determination that the Wherry corporations realized capital gain during the year 1957 when their properties were taken by the United States, it is unnecessary to decide the date of the execution of the so-called three-party agreements with respect to the various mortgages. It follows from our determination that the gain was realized in the calendar year 1957, that this same gain was not realized by Ord and Monterey after February 11, 1958, even though certain of the signatures to the three-party agreements did not occur until after this date.

It is not clear on what facts petitioners base their contention that the bases of the properties on the books of the Wherry corporations are not their bases for the purposes of a computation of gain on condemnation. Apparently, from the testimony of petitioners' accounting witness that the book figures correctly reflect the bases of the corporations in the properties except for "prepaid items," it is petitioners' position that the bases of the properties should be

increased by the amount at the date of condemnation of the deposit in escrow by each of the Wherry corporations with the mortgagee. The burden is on petitioners to show error in respondent's determination and petitioners have totally failed to show that the amounts deposited in escrow were not returned to them by the mortgagees after the condemnation of the property. If petitioners' argument about bases is on any other ground, petitioners have not so stated.

The loan agreement under which the projects were financed are not in evidence and nothing is in evidence to show what disposition was made of the escrow deposits with the mortgagees after title to the properties passed to the United States. We therefore cannot assume that the sums were not returned to the Wherry corporations prior to February 10, 1958. The three-party agreements indicate that these funds are to be repaid to the mortgagor. Petitioners object to these agreements on the ground that the Wherry corporations were not a party to them. However, we need not consider the indication from these agreements since petitioners have not proved that the escrow deposits were not in fact returned to them.

The next issue with respect to the gain on the condemnation is whether the four Wherry corporations realized a taxable gain during their fiscal year ended June 30, 1959, because of the withdrawal during August and September of 1958 of amounts which had been deposited with the Court by the United States at the time of the filing of the declarations of taking and an amended declaration of taking. Petitioners apparently recognize that respondent is correct in his contention that these withdrawals constituted receipts with respect to the sale of the properties which would result in gain if they were in excess of basis. Petitioners' argument with respect to these withdrawals is first that since the properties were still subject to mortgages on which the Wherry corporations were liable, the withdrawals in August and September of 1958 were less than the bases of the Wherry corpora-

tions in the properties and therefore no gain was realized. Since we have held that upon the taking of the properties by the United States in 1957, the Wherry corporations realized gain to the extent that the principal liabilities on the mortgages exceeded their bases in the properties, it follows that the Wherry corporations each recovered its entire basis in the properties in 1957 and that the entire amount of the withdrawals in 1958 represented gain.

Petitioners' next argument is that if gain was realized on the withdrawal of the deposits, it is not to be recognized for tax purposes under the provisions of section 337.[21] This section provides that if a corporation adopts a plan of complete liquidation on or after June 22, 1954, and within the 12-month period beginning with the date of the adoption of the plan, all of the assets of the corporations are distributed in complete liquidation, no gain or loss shall be recognized to that corporation from the sale or exchange by it of property within such 12-month period. The facts show that the Wherry corporations adopted a plan of complete liquidation on August 11, 1958, and distributed all of their assets and completed their liquidation on August 8, 1959, within a 12-month period. Therefore, the only provision of section 337 which respondent contends the Wherry corporations do not come within is the requirement that their properties be sold within the 12-month period after the adoption of the plan of liquidation.

This question has arisen in a number of cases. Our Court as well as other courts, has held that in determining the date

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21. SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) General Rule.—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

of sale for the purpose of section 337 where a condemnation has taken place, the sale occurs when title passes in accordance with the law governing the condemnation proceeding, and if title passes on the date of the commencement of the condemnation suit, a corporation does not come within the nonrecognition-of-gain provisions under section 337 with respect to the sale if it adopts a plan of complete liquidation after the commencement of suit and passing of title. *44 West 3rd Street Corporation,* 39 T. C. 809 (1963), affirmed sub nom. *Wendell v. Commissioner,* 326 F.2d 600 (C. A. 2, 1964); *Dwight v. United States,* 328 F.2d 973 (C. A. 2, 1964); and *Harriet Fibel,* 44 T. C. 647 (1965). These cases all involved condemnations under New York Law and concluded under that law that title vested and the sale occurred for the purposes of section 337(a) on the date the order of condemnation was entered.

The condemnation in the instant case is under 40 U. S. C., section 258a[22] which provides that a declaration of taking may be filed by the United States, and that upon the filing of such a declaration of taking, and the making of a deposit in Court to the use of the persons entitled thereto, "title to the said lands in fee simple absolute, or such less estate or interest therein as is specified in said declaration, shall vest in the United States of America, and said lands shall be deemed to be condemned and taken for the use of the United States, and the right to just compensation for the same shall vest in the persons entitled thereto; * * *." This section clearly provides for the passing of title to the United States upon the filing of the declaration of taking and the deposit of moneys in the Court which, as we have stated heretofore, were deposited in accordance with the provisions of 40 U. S. C. 258 and 42 U. S. C. 1594a.

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22. This same section of the United States Code was involved in *Covered Wagon, Inc.*, T. C. Memo. 1965-79, in which he held that the "sale" occurred on the date of the filing of the declaration of taking for the purposes of sec. 337(a).

Since the sale of the property occurred prior to the adoption on August 11, 1958, of a plan of complete liquidation by the Wherry corporations, the provisions of section 337(a) are not applicable with respect to Wherry corporations' properties condemned by the United States, and therefore these corporations did realize gain upon the withdrawal of the funds deposited by the United States in the District Court in which the condemnation proceedings were pending. *44 West 3rd Street Corporation, supra,* and *Harriet Fibel, supra.* We therefore sustain respondent in his determination that the Wherry corporations each received a gain from the sale of the properties during the fiscal year ended June 30, 1959, because of the withdrawal of funds in August and September 1958 from the deposits in the District Courts.

Claimed Deductions for Administration Expenses

Issue 7

Respondent disallowed a net amount of $325,000 of deductions claimed by Honolulu and subsidiaries as administrative expenses, finance fees, and interest expenses on the ground that they did not represent ordinary and necessary expenses or an allowable deduction. The facts show that Foster personally negotiated for financing fees for two housing projects to be built by Honolulu in Honolulu, Hawaii. These projects were known as Harbor Heights and Foster Village. The evidence also shows that the financing which was arranged and obtained to enable Honolulu to proceed with these two projects was in such an amount that a $80,000 fee for services in arranging the financing was a reasonable amount in an arm's-length transaction between unrelated parties. Two of the sums, one in the amount of $50,000 and one in the amount of $30,000, were paid by Honolulu to Foster for his services as an officer of the corporation arranging for the availability of financing for the property and are deductible by Honolulu as ordinary and necessary

business expenses unless they should be considered as a part of the cost of the projects. Although the evidence is not completely clear it shows to our satisfaction that the services were in connection with the general financial problems of Honolulu and therefore a business expense and not a capital expenditure.

A portion of the remaining $245,000 of deductions was payments to Foster as salary. It is not completely clear from the record as to the payments that were for salary but we are satisfied that the two items of administrative expense, one charged to Foster Development and one charged to Foster Homes totaling $180,000, represent a payment of salary of $105,000 to Foster and a $75,000 payment to the partnership, Foster & Sons. The payment of $105,000 to Foster was charged to Foster Development and deducted by it. This was the company that developed Foster Village for Honolulu, a project consisting of 525 houses. Because of the size of this project and the necessity for obtaining interim financing for its construction as well as permanent financing, we consider the record to be sufficient to show that the $105,000 was a reasonable salary payment to Foster and that this amount is deductible by Foster Development as an ordinary and necessary business expense. We therefore sustain petitioners' position that deductions to the extent of $185,000 of the claimed $325,000 disallowed by respondent are properly allowable.

There is nothing in the record to show the basis of the payment of the $75,000 to Foster & Sons or what was included in the $142,351.07 for other corporate expenses. These amounts may have been capital expenditures or for other reasons not deductible expenses. We therefore sustain respondent in the disallowance of these deductions because of petitioners' failure to show error in that disallowance.

The other item involved is an interest expense deduction by Foster Homes of $22,648.02. The evidence shows that Foster personally advanced some funds in connection with the development of Harbor Heights and Foster Village. The

evidence further shows that $250,000 of the $325,000 of disallowed expense deductions represented amounts paid to Foster and $75,000 represented amounts paid to the partnership, Foster & Sons. It therefore appears that the $22,648.93 was paid to Foster and reported by him as income on his personal income tax return as were the amounts of the other payments to him by the various corporations. Certainly Foster is entitled to receive interest from the corporations on personal funds advanced. Although the proof is not as clear as it might be, we conclude that the interest expense was paid to Foster in connection with advancements of funds and that the funds were advanced in connection with the business activities of Foster Homes in the construction of houses in Foster Village and therefore the $22,648.02 interest payment is a proper deduction by Foster Homes in the computation of its taxable income.

Whether Honolulu Had a Gain from Distributions in Liquidation by the Wherry Corporations

Issue 8

Respondent takes the position that since amounts of $463,226 and $318,827 were withdrawn from the District Court by Ord and Monterey, respectively, and the amounts of $171,500 and $166,500 were withdrawn from the District Court by Biggs and El Paso, respectively, pursuant to the orders of those courts permitting the withdrawal by those corporations, the amounts became the property of the Wherry corporations and were distributed by those corporations to Honolulu and the other stockholders of the Wherry corporations as a liquidating dividend.

The facts show that all of the amounts withdrawn totaling $1,120,053 were placed in Honolulu's bank account. The fact alone would not necessarily show that the amounts were distributed to the stockholders of the Wherry corporations, since it apparently was not uncommon for funds of one of the related group of corporations to be placed in the bank ac-

count of another related corporation. However, the entry of September 5, 1958, on Honolulu's books of a credit of $888,576.13 to "Gain on Sale of Assets" and the making of appropriate credit on Honolulu's books to Foster and his sons, the other stockholders in the Wherry corporations, indicate that a distribution of the amount of $888,576.13 was made by the Wherry corporations to Honolulu in the fiscal year ended June 30, 1959. Shortly prior to the entry of the $888,576.13 on the books of Honolulu as a "Gain on Sale of Assets," the Wherry corporations had adopted plans of liquidation. Therefore the distributions were distributions on liquidation.

The record shows that all of the assets of each of the Wherry corporations were distributed to its shareholders before August 8, 1959, when the liquidations were completed.

Petitioners apparently are not contending that the distributions of $888,576.13 were not made to Honolulu by the Wherry corporations during the year ended June 30, 1959, but apparently are contending that the bases of the assets of the Wherry corporations with respect to which the amounts were distributed, exceeded the amounts of the distributions. We have previously held that each of the Wherry corporations recovered the full basis of its assets prior to the close of the calendar year 1957 and this would dispose of this argument of petitioners were it relevant. However, the relevant fact with respect to whether gain is realized on a distribution to stockholders in liquidation is not the basis of the assets of the distributing corporation but the basis of the stockholder to which the distribution is made in the stock of the distributing corporation. We have previously discussed the fact of the redemptions of the class A common stock of Ord and Monterey so that it is apparent Honolulu had a basis of zero in the class A common stock of each of those two corporations at the date of distribution of the funds withdrawn from the District Court in 1958. There is nothing in the record to show the bases of Honolulu in the class A

common stock of Biggs and El Paso or any adequate proof of its basis in the class B stock of any of the corporations.

In connection with the allocation between class A and class B stock of losses availed of by Monterey which would not have been available to it except for the filing of a consolidated return, we put a basis of $15,000 on the class B stock of Monterey from a balance sheet figure appearing in the record. We took this balance sheet figure because of the fact that respondent had the burden of proof and had not shown that this amount did not represent Honolulu's basis in the stock. However, in the instant case respondent determined that the full $888,576.13 was taxable to Honolulu as a liquidating distribution and therefore the burden of showing that a lesser amount is taxable to Honolulu is on petitioners.

Section 331 provides that amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and respondent has in his notice of deficiency so treated the distribution of $888,576.13 to Honolulu by treating the amount as a capital gain to Honolulu. Petitioners in their reply brief, make the statement that "Honolulu Corp. received the cash either as a liquidating dividend or as a collection on the chose-in-action which Honolulu Corp. was to receive as a result of the liquidation," and that if the amount were received as a liquidating dividend, it "is not the gross assets received, but the net amount determined by the liabilities to which the assets received may be subject." Petitioners argue that if the cash was received as a collection on a claim against the United States, Honolulu's basis in the claim exceeded the cash receipts. The evidence fails to show that any chose-in-action against the United States had been distributed by the Wherry corporations to Honolulu prior to the cash distribution here involved. Therefore the only argument made by petitioners against respondent's treatment of the $888,576.13 as having been received as a liquidating dividend which we need to consider further is petitioners' contention that the

cash received was subject to liabilities so that the net amount should be determined as having been received. A comparison of the liabilities shown on the balance sheet of the Wherry corporations as of June 30, 1958 and June 30, 1959, indicates that the distribution made in August 1958 was not subject to any liabilities. At that time the claims against the United States are not shown to have been distributed and it is not shown that such claims would not be of sufficient value to discharge any liabilities that the Wherry corporations had. If at some later date it were determined that some liability did exist which Honolulu was required to pay, the amount would be a capital loss to Honolulu in a later year. *Arrowsmith v. Commissioner,* 344 U. S. 6 (1952). If petitioners had in mind some liability of Honolulu as a transferee for income taxes of the Wherry corporations, the amounts would not be proper reductions of the distributions but any adjustment would be made in Honolulu's income in the year that the liability for such taxes is determined or paid. *James Armour, Inc.,* 43 T. C. 295, 312 (1964). We therefore sustain respondent in his determination that the entire $888,576.13 constituted a capital gain to Honolulu in its fiscal year ended June 30, 1959.

Transferee Liability

Issue 9

It is not clear that petitioners contest the determination of transferee liabilities against Honolulu, Foster, and his sons except insofar as they contest the liabilities determined against the transferor corporations. The facts we have set forth and our ultimate facts on this issue dispose of the extent of the liability of Honolulu, Foster, and each of Foster's three sons as transferees of the Wherry corporations. If there is an issue in respect to the transferee liability, we hold that the extent of the liability of each of the transferees is as set forth in our ultimate finding on this issue.

Decisions will be entered under Rule 50.

Appendix C

In The Tax Court of the United States

No. 1088-64

T. Jack Foster, et al.,
Petitioners,
vs.
Commissioner or Internal Revenue,
Respondent.

Supplemental Memorandum Findings of Fact and Opinion

SCOTT, Judge: Certain substantive differences arose between the parties in their computations under Rule 50 submitted to the Court resulting in amendments to the pleadings being filed by the parties. Petitioners filed a motion to amend their petition which included a proposed amendment relating to loss carrybacks from years subsequent to the years here in issue. Petitioners later withdrew their motion insofar as it related to such claimed loss carrybacks, thus causing the area of disagreement between the parties to center on the basis of Likins-Foster Honolulu Corporation (hereinafter referred to as Honolulu) in the stock of Likins-Foster Monterey Corporation (hereinafter referred to as Monterey) for computing gain on redemption by Monterey in the fiscal year ended June 30, 1957, of its class A stock and the basis of Honolulu in the stock of Monterey, Likins-Foster Ord Corporation, Likins-Foster El Paso Corporation, and Likins-Foster Biggs Corporation for the purpose of computing Honolulu's gain from amounts received from these corporations in the fiscal year ended June 30, 1959, after the corporations had passed resolutions of dissolution and liquidation. The difference between the parties as to the basis of Honolulu in the class A stock of Monterey for computing Honolulu's gain for the fiscal year 1957 is whether the basis

of the class A and class B stock is $215,000 or $230,000. In our Memorandum Findings of Fact and Opinion, filed December 27, 1966, we stated:

> * * * It may be that the class B stock did not have a basis of $15,000 in addition to the $215,000 basis stipulated to be that of the class A stock, but respondent has failed to show that this is a fact and therefore we hold that in prorating the reduction in basis to the various classes of stock the value of the class A stock to be used is $215,000 and the value of the class B stock is $15,000.

Our conclusion as to the original basis of Honolulu in the class A and class B stock of Monterey is in accordance with our Memorandum Findings of Fact and Opinion, filed December 27, 1966.

The total amount of losses of Monterey for the fiscal years ended June 30, 1954, 1955, and 1956, which were used in computing its consolidated net income with Honolulu and subsidiaries for those years is set forth in our Memorandum Findings of Fact and Opinion, filed December 27, 1966, as being in the amounts of $23,877, $78,664, and $72,090, respectively. The total of these amounts is $174,631. However, the parties apparently are in agreement in the proposed recomputations that the total of these losses is $174,631.63, and we now determine this to be the amount of such losses.

In our Memorandum Findings of Fact and Opinion filed December 27, 1966, we determined that the basis of Honolulu in the stock of Monterey to be used in computing the gain by Honolulu from distributions in liquidation received from Monterey in the fiscal year 1959 was zero. Petitioners in their Rule 50 computation used a basis of Honolulu in Monterey's stock, in computing gain for the fiscal year 1959 in the amount of $171,897.69 plus certain amounts representing taxes of Monterey which petitioners claimed after the entry of decision in this case Honolulu would be required to pay, an issue which will be hereinafter discussed. It is petitioners' contention that the facts as set forth in our Memorandum Find-

ings of Fact and Opinion filed December 27, 1966, show that a greater reduction in the basis of Honolulu in Monterey's stock should be used in computing Honolulu's gain on redemption of Monterey's stock in the fiscal year 1957 than the amount of such reduction which had been claimed by respondent and determined by the Court and that the making of the adjustment reducing Honolulu's basis in the fiscal year 1957 because of previously used losses requires a contra-adjustment in the fiscal year 1959. The parties agreed that respondent might file an amendment to his amended answer claiming the increase deficiency resulting from the decrease in Honolulu's basis in Monterey's stock for computing Honolulu's gain upon redemption of such stock in the fiscal year 1957 and that petitioners might file an amended petition claiming the reduction in Honolulu's tax in the fiscal year 1959 resulting from using as Honolulu's basis in Monterey's stock the amount petitioners claimed to be the proper amount for computing Honolulu's gain for that year. Such amendment to amended answer and amended petition were filed. It is petitioners' position that the following provisions of section 1.1502-34A(a), (b)(1) and (2) and (c)(1) and (2), Income Tax Regulations, support their method of determining Honolulu's basis in Monterey's stock for the purpose of computing the gain of Honolulu from the amount received as a liquidating distribution from Monterey in the fiscal year 1959:

Section 1.1502-34A Sale of stock; basis for determining gain or loss.

(a) *Scope of section.* This section prescribes the basis for determining the gain or loss upon any sale or other disposition (hereinafter referred to as "sale") by a corporation which is (or has been) a member of an affiliated group which makes (or has made) a consolidated return for any taxable year, of any share of stock issued by another member of such group (whether issued before or during the period that it was a member of the group and whether issued before, during, or

after the taxable year 1929), and held by the selling corporation during any part of a period for which a consolidated return is made or required under the regulations under section 1502. * * *

(b) *Sales made while selling corporation is member of affiliated group.* If the sale is made within a period during which the selling corporation is a member of the affiliated group, whether or not during a consolidated return period, and whether or not, as a result of such sale, the issuing corporation ceases to be a member of the group, the basis shall be determined as follows:

(1) The aggregate bases of all shares of stock of the issuing corporation held by each member of the affiliated group (exclusive of the issuing corporation) immediately prior to the sale, shall be determined separately for each member of the group, and adjusted in accordance with the other provisions of subtitle A of the Code, but without regard to any adjustment under the last sentence of section 1051 relating to losses of the issuing corporation sustained by such corporation after it became a member of the group.

(2) From the combined aggregate bases as determined in subparagraph (1) of this paragraph, there shall be deducted the sum of—

(i) All losses of such issuing corporation sustained during taxable years for which consolidated income tax returns were made or were required (whether the taxable year 1929 or any prior or subsequent taxable year) after such corporation became a member of the affiliated group and prior to the sale of the stock to the extent that such losses could not have been availed of by such corporation as net loss or net operating loss in computing its net income or taxable income, as the case may be, for such taxable years if it had made a separate return for each of such years,

* * *

reduced by any losses of the issuing corporation apportioned under this section to its stock sold or otherwise disposed of in a prior transaction, disregarding any transaction between members of the affiliated group during a consolidated income or excess profits tax return period which did not constitute a partial liquidation of the issuing corporation. * * *

* * *

(c) *Sales after selling corporation has ceased to be member of affiliated group.* If the sale is made after the selling corporation has ceased to be a member of the affiliated group, such basis shall be determined in accordance with paragraph (b) of this section, except that—

(1) The aggregate basis (under paragraph (b)(1) of this section) shall be determined for all shares of the issuing corporation held by each member of the group immediately prior to the time the selling corporation ceased to be a member of the group (rather than immediately prior to the sale);

(2) The reduction (under paragraph (b)(2) of this section) with respect to losses apportioned to stock sold or otherwise disposed of in prior transactions shall be determined without regard to the transaction which terminated the affiliation and all subsequent transactions;

* * *

Petitioners interpret the provision, "The aggregate bases of all shares of stock of the issuing corporation held by each member of the affiliated group * * * immediately prior to the sale * * * shall be * * * adjusted in accordance with the other provisions of subtitle A of the Code * * *" to require starting with an $11,900 basis of Honolulu in Monterey's stock as of the year 1959, which represents the amount they consider to be the portion of a $15,000 original basis of Honolulu in Monterey's class B stock which is not applicable to the stock

transferred in February 1958 when Monterey ceased to be a part of the affiliated group entitled or required to file consolidated returns. Petitioners then state that under the provisions of paragraph 1.1502-34A(b)(2) there is no amount or zero amount of losses of such issuing corporation sustained during taxable years for which consolidated income tax returns were made that "could not have been availed of by such corporation as net loss or net operating loss in computing its net income * * * if it had made a separate return for each of such years," since Monterey's income computed in accordance with the opinion of this Court was sufficient for the fiscal year 1958 and for that portion of that year prior to February 1958 when it ceased to be a part of the consolidated group to have offset all of its prior losses both separate and those previously used by the consolidated group. Petitioners state that, therefore Honolulu's original basis in Monterey's stock is to be reduced by zero minus any "losses of the issuing corporation apportioned under this section to its stock sold or otherwise disposed of in a prior transaction, * * *." Petitioners state this results in the amount to be subtracted from $11,900 being a minus amount, which requires that the $11,900 be increased by such amount.

We stated in our Memorandum Findings of Fact and Opinion, filed December 27, 1966, as follows:

> In connection with the allocation between class A and class B stock of losses availed of by Monterey which would not have been available to it except for the filing of a consolidated return, we put a basis of $15,000 on the class B stock of Monterey from a balance sheet figure appearing in the record. We took this balance sheet figure because of the fact that respondent had the burden of proof and had not shown that this amount did not represent Honolulu's basis in the stock. However, in the instant case respondent determined that the full $888,576.13 was taxable to Honolulu as a liquidating distribution and therefore the burden of showing that a lesser amount is taxable to Honolulu is on petitioners.

We do not consider the facts in this case to be sufficient to show that Honolulu's original basis in the class B stock of Monterey was $15,000, or if such were the original basis, what portion of such original basis should be allocated to the portion of Monterey's stock which Honolulu disposed of in its fiscal year 1958 when Monterey ceased to be a member of the consolidated group.

We therefore conclude that Honolulu's original basis in Monterey's stock to be used for the purpose of computing Honolulu's gain from the distribution received by it from Monterey in the fiscal year 1959 is zero. However, if an original basis of zero is used for the class B stock, it is still necessary to determine whether petitioners are correct that the zero basis should be reduced by zero minus the amount of the 1957 adjustment so that the basis in 1959 is the amount by which the 1957 basis was reduced. The purpose of the regulation requiring the adjustment for previous losses used by the consolidated group which could not have been used by the member of the consolidated group if that member had filed separate returns is to avoid a double use of losses and the purpose of, in effect, restoring prior apportioned losses is not to have an adjustment which results in effect in denial of one use of such losses. Here the income of Monterey for the portion of the year it was a member of the consolidated group in the fiscal year 1958 in accordance with our Memorandum Findings of Fact and Opinion, filed December 27, 1966, is approximately $600,000. Therefore, it had sufficient income in this year to use its approximately $112,000 of separate losses, the approximately $174,000 of its losses used by the consolidation in prior years, and the approximately $49,000 loss in the fiscal year 1957. Therefore, there were not as of the time in 1958 when Monterey was removed from the consolidated group any losses for any prior year which it could not have used if it had filed separate returns. Therefore, in 1959 it is necessary to correct for an adjustment made in 1957 when circumstances were different in this respect. This correction results in the basis of Hono-

lulu in the stock of Monterey in the fiscal year 1959 being the same amount as the reduction in Honolulu's basis in Monterey stock in the fiscal year 1957 computed under section 1.1502-34A(b)(2) of respondent's regulations.

In our Memorandum Findings of Fact and Opinion, filed December 27, 1966, we stated with respect to petitioners' contenton that there were liabilities of Likins-Foster Ord Corporation, Likins-Foster Biggs Corporation, Likins-Foster El Paso Corporation, and Monterey which should be used to reduce the distributions by those corporations to Honolulu before computing any gain to Honolulu in its fiscal year 1959 from such distributions, as follows:

> * * * If at some later date it were determined that some liability did exist which Honolulu was required to pay, the amount would be a capital loss to Honolulu in a later lear. *Arrowsmith v. Commissioner,* 344 U. S. 6 (1952). If petitioners had in mind some liability of Honolulu as a transferee for income taxes of the Wherry corporations, the amounts would not be proper reductions of the distributions but any adjustment would be made in Honolulu's income in the year that the liability for such taxes is determined or paid. *James Armour, Inc.,* 43 T. C. 295, 312 (1964).

Petitioners argue that since Honolulu is not only liable as a transferee of its former subsidiaries but also because for some years prior to the fiscal year 1959 it filed consolidated returns with these affiliates, the holdings in *Arrowsmith v. Commissioner,* 344 U. S. 6 (1952), and *James Armour, Inc.,* 43 T. C. 295 (1964), are inapplicable. Any deficiencies in tax which may be determined when the decision of this Court is entered with respect to Monterey and other "Wherry" corporations which Honolulu is required to pay are not a liability which is finally determined until the decision of this Court is entered. It was because such liability was not fixed or paid until a later year, and not merely because the liability was a transferee liability, that formed the basis of the hold-

ing in *Arrowsmith v. Commissioner, supra,* and in *James Armour, Inc., supra,* that the deduction should be taken in the later year. Therefore under the holdings of these cases, Honolulu is not entitled to deduct any amounts of the liabilities of the "Wherry" corporations which it may ultimately be called upon to pay until they are either finally determined or paid. In effect, Honolulu is attempting to obtain a deduction for the yet undetermined taxes of the "Wherry" corporations which it may eventually be called upon to pay by reducing its gain from liquidating distributions from such corporations in the fiscal year 1959 by the yet undetermined amounts.

An appropriate order will be entered in Docket No. 1088-64.

Appendix D

STATUTES INVOLVED

Internal Revenue Code of 1954:

Sec. 269. Acquisitions made to evade or avoid income tax

(a) In general.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For purposes of paragraphs

(1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

(b) Power of Secretary or his delegate to allow deductions, etc., in part.—In any case to which subsection (a) applies the Secretary or his delegate is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

(c) Presumption in case of disproportionate purchase price.—The fact that the consideration paid upon an acquisition by any person or corporation described in subsection (a) is substantially disproportionate to the aggregate—

(1) of the adjusted basis of the property of the corporation (to the extent attributable to the interest acquired specified in paragraph (1) of subsection (a)), or of the property acquired specified in paragraph (2) of subsection (a); and

(2) of the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such person or corporation otherwise than as a result of such acquisition,

shall be prima facie evidence of the principal purpose of evasion or avoidance of Federal income tax. This subsection shall apply only with respect to acquisitions after March 1, 1954.
(26 U.S.C. 269.)

Sec. 337. Gain or loss on sales or exchanges in connection with certain liquidations

(a) General rule.—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

(b) Property defined.—

(1) In general.—For purposes of subsection (a), the term "property" does not include—

(A) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year, and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business,

(B) installment obligations acquired in respect of the sale or exchange (without regard to whether such sale or exchange occurred before, on, or after the date

of the adoption of the plan referred to in subsection (a)) of stock in trade or other property described in subparagraph (A) of this paragraph, and

(C) installment obligations acquired in respect of property (other than property described in subparagraph (A)) sold or exchanged before the date of the adoption of such plan of liquidation.

(2) Nonrecognition with respect to inventory in certain cases.—Notwithstanding paragraph (1) of this subsection, if substantially all of the property described in subparagraph (A) of such paragraph (1) which is attributable to a trade or business of the corporation is, in accordance with this section, sold or exchanged to one person in one transaction, then for purposes of subsection (a) the term "property" includes—

(A) such property so sold or exchanged, and

(B) installment obligations acquired in respect of such sale or exchange.

(c) Limitations.—

(1) Collapsible corporations and liquidations to which section 333 applies.—This section shall not apply to any sale or exchange—

(A) made by a collapsible corporation (as defined in section 341(b)), or

(B) following the adoption of a plan of complete liquidation, if section 333 applies with respect to such liquidation.

(2) Liquidations to which section 332 applies.—In the case of a sale or exchange following the adoption of a plan of complete liquidation, if section 332 applies with respect to such liquidation, then—

(A) if the basis of the property of the liquidating corporation in the hands of the distributee is deter-

mined under section 334(b) (1), this section shall not apply; or

(B) if the basis of the property of the liquidating corporation in the hands of the distributee is determined under section 334(b) (2), this section shall apply only to that portion (if any) of the gain which is not greater than the excess of (i) that portion of the adjusted basis (adjusted for any adjustment required under the second sentence of section 334(b) (2)) of the stock of the liquidating corporation which is allocable, under regulations prescribed by the Secretary or his delegate, to the property sold or exchanged, over (ii) the adjusted basis, in the hands of the liquidating corporation, of the property sold or exchanged.

(d) Special rule for certain minority shareholders.—If a corporation adopts a plan of complete liquidation on or after January 1, 1958, and if subsection (a) does not apply to sales or exchanges of property by such corporation, solely by reason of the application of subsection (c) (2) (A), then for the first taxable year of any shareholder (other than a corporation which meets the 80 percent stock ownership requirement specified in section 332(b) (1)) in which he receives a distribution in complete liquidation—

(1) the amount realized by such shareholder on the distribution shall be increased by his proportionate share of the amount by which the tax imposed by this subtitle on such corporation would have been reduced if subsection (c) (2) (A) had not been applicable, and

(2) for purposes of this title, such shareholder shall be deemed to have paid, on the last day prescribed by law for the payment of the tax imposed by this subtitle on such shareholder for such taxable year, an amount of tax equal to the amount of the increase described in paragraph (1).

(26 U.S.C. 337.)

Sec. 482. Allocation of income and deductions among taxpayers

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.
(26 U.S.C. 482.)

Sec. 1501. Privilege to file consolidated returns

An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.
(26 U.S.C. 1501.)

Sec. 1502. Regulations

The Secretary or his delegrate shall prescribe such regulations as he may deem necessary in order that the tax lia-

bility of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

(26 U.S.C. 1502.)

Sec. 1503. Computation and payment of tax

(a) General rule.—In any case in which a consolidated return is made or is required to be made, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under section 1502 prescribed before the last day prescribed by law for the filing of such return.

(b) Special rule for application of foreign tax credit when overall limitation applies.—

(1) In general.—If the affiliated group includes one or more Western Hemisphere trade corporations (as defined in section 921), and if for the taxable year an election under section 904 (b) (1) (relating to election of overall limitation on foreign tax credit) is in effect, then the amount of taxes paid or accrued to foreign countries and possessions of the United States by such Western Hemisphere trade corporations which may be taken into account for purposes of section 901 shall be reduced by the amount (if any) by which—

(A) the amount of such taxes (or, if smaller, the amount of the tax which would be computed under subsection (a), if such corporations were not Western Hemisphere trade corporations, with respect to the portion of the consolidated taxable income attributable to such corporations), exceeds

(B) the amount of the tax computed under subsection (a) with respect to the portion of the consolidated taxable income attributable to such corporations.

(2) Adjustment in case of certain public utilities.—So much of any reduction under paragraph (1) as is attributable to taxes paid or accrued to foreign countries and possessions of the United States by one or more corporations which are both Western Hemisphere trade corporations and regulated public utilities shall be decreased by the excess of—

(A) the amount of tax computed under subsection (a) with respect to the portion of the consolidated taxable income attributable to income derived, by the corporations in the affiliated group which are not Western Hemisphere trade corporations, from sources within the foreign countries referred to in paragraph (3) (B), over

(B) the amount of taxes paid or accrued to such foreign countries by the corporations referred to in subparagraph (A).

This paragraph shall apply only if the corporations described in subparagraph (A) derive 80 percent or more, of the gross income (computed without regard to capital gains and losses) which they derive from sources within the foreign countries described in paragraph (3) (B), from regulated public utilities and from operations as regulated public utilities.

(3) Special rules.—

(A) For purposes of paragraph (2), a corporation is a regulated public utility only if it is a regulated public utility within the meaning of subparagraph (A) (other than clauses (ii) and (iii) thereof) or (D) of section 7701(a)(33). For purposes of the preceding sentence, the limitation contained in the last two

sentences of section 7701(a)(33) shall be applied as if subparagraphs (A) through (F), inclusive, of section 7701(a)(33) were limited to subparagraphs (A)(i) and (D) thereof.

(B) For purposes of paragraph (2), the foreign countries referred to in this subparagraph include only any country from which any public utility referred to in the first sentence of paragraph (2) derives the principal part of its income.

(C) For purposes of this subsection, the term "consolidated taxable income" means the consolidated taxable income computed without regard to the deduction provided by section 242 for partially tax-exempt interest.

(26 U.S.C. 1503.)

Sec. 1504. Definitions

(a) Definition of "affiliated group."—As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include non-voting stock which is limited and preferred as to dividends.

(b) Definition of "includible corporation."—As used in this chapter, the term "includible corporation" means any corporation except—

(1) Corporations exempt from taxation under section 501.

(2) Insurance companies subject to taxation under section 802 or 821.

(3) Foreign corporations.

(4) Corporations entitled to the benefits of section 931, by reason of receiving a large percentage of their income from sources within possessions of the United States.

(5) Corporations organized under the China Trade Act, 1922.

(6) Regulated investment companies and real estate investment trusts subject to tax under subchapter M of chapter 1.

(7) Unincorporated business enterprises subject to tax as corporations under section 1361.

(c) Includible insurance companies.—Despite the provisions of paragraph (2) of subsection (b), two or more domestic insurance companies each of which is subject to taxation under the same section of this subtitle shall be considered as includible corporations for the purpose of the application of subsection (a) to such insurance companies alone.

(d) Subsidiary formed to comply with foreign law.—In the case of a domestic corporation owning or controlling, directly or indirectly, 100 percent of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic crporation, be treated for the purpose of this subtitle as a domestic corporation.

(26 U.S.C. 1504.)

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In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 1037

LIKINS-FOSTER HONOLULU CORP., et al.,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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In the Supreme Court of the United States

OCTOBER TERM, 1969

No. .....

LIKINS-FOSTER HONOLULU CORP., et al.,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

Likins-Foster Honolulu Corp.; Aliamanu Homes Limited; Likins-Foster Olathe Corp.; Likins-Foster Topeka Corp.; Likins-Foster Salina Corp.; Cochiti Pumice Company, Lomita Homes, Inc.; Cardiff Homes, Inc.; Highland Park Homes, Inc.; Biggs Rental Co.; Foster Homes, Ltd.; Foster Development Corp.; Central Development Co., Ltd.; Likins-Foster Ord Corp., a liquidated corporation; Likins-Foster Monterey Corp., a liquidated corporation; Likins-Foster Biggs Corp., a liquidated corporation; and Likins-Foster El Paso Corp., a liquidated corporation, respectfully

pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Tenth Circuit entered in this proceeding on November 16, 1969.

OPINIONS BELOW

The opinion of the Court of Appeals has not yet been officially reported. It is unofficially reported at 69-2 U.S.T.C. ¶ 9672 and is reproduced in Appendix A hereto. The opinions of the Tax Court of the United States are reported at 25 T.C.M. 1390 (1966) and 26 T.C.M. 1021 (1967). The Tax Court opinions are reproduced in Appendices B and C hereto.

JURISDICTION

The judgment of the Court of Appeals (App. A, p. 14)[1] was entered on November 16, 1969. The jurisdiction of this court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the date of the "sale or exchange" for purposes of section 337 of the Internal Revenue Code of 1954, a remedial measure designed to avoid double taxation on sales or exchanges in corporate liquidations, is the date title and possession pass, or is the date gain would be realized on the sale or exchange under ordinary circumstances. The setting in which the question arises is a condemnation of property, where the court below applied a different rule than that applied in other types of involuntary conversions and in consensual sales.

2. Whether an accrual basis taxpayer realizes gain from a sale pursuant to a condemnation, prior to the date the litigation over the amount of the condemnation award is terminated.

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1. "App." refers to the appendix to this petition. "R." references are to printed record in this case, the appendix in the Court of Appeals.

3. Whether Internal Revenue Code section 482 authorizes allocating the entire profit from one member of a consolidated return group to another, in a manner contrary to the consolidated return regulations, where the trial court has found that tax avoidance would otherwise occur but the provisions of sections 269 and 1551, dealing with transfers to avoid tax, do not apply.

STATUTORY PROVISIONS INVOLVED

Internal Revenue Code of 1954:

Sec. 269. Acquisitions made to evade or avoid income tax. (26 U.S.C. 269.)

Sec. 337. Gain or loss on sales or exchanges in connection with certain liquidations. (26 U.S.C. 337.)

Sec. 482. Allocation of income and deductions among taxpayers. (26 U.S.C. 482.)

Sec. 1501. Privilege to file consolidated returns. (26 U.S.C. 1501.)

Sec. 1502. Regulations. (26 U.S.C. 1502.)

Sec. 1503. Computation and payment of tax. (26 U.S.C. 1503.)

Sec. 1504. Definitions. (26 U.S.C. 1504.)

The above sections are reproduced in Appendix D hereto.

STATEMENT OF THE CASE

Likins-Foster Honolulu Corp. (hereinafter referred to as Honolulu Corp.) owned all the stock of Topeka Corp.[2] and, until February 10, 1958, of the four Wherry corporations,[3] and filed consolidated returns including them. After

2. Likins-Foster Topeka Corp.

3. Likins-Foster Ord Corp.; Likins-Foster Monterey Corp.; Likins-Foster Biggs Corp.; Likins-Foster El Paso Corp. The separate incorporation of the four was for business reasons appearing in the Tax Court's findings. (App. B, p. 28.)

the consolidation was broken, the Wherry corporations filed separate returns until they were dissolved. (App. B, pp. 26-27.) The returns were on the accrual basis.

a. Topeka Corp. owned 421 rental houses and duplexes in Topeka, Kansas, which it sold on July 1, 1956 to the four Wherry corporations for a profit of $882,967.39. (App. B, pp. 28-29.) This followed a policy decision to dispose of these properties to the public, because of recent business developments. The Wherry corporations continued the rental business with the same staff for a year, but added persons to handle the sales. (App. B, pp. 29-30.) The 421 buildings were sold at retail in individual sales in June, 1957 (App. 30), for prices totaling $387,654 more than the Wherry corporations had paid for them (App. B, p. 30).

The gains from these sales were reported in the consolidated return as gains by the Wherry corporations, because the Topeka sale to them was treated as an intercompany transaction under the consolidated return regulations. (App. B, pp. 30-31.) It was offset against the Wherry corporations net operating loss carryovers, some of which antedated the first year they were included in the consolidated return. (App. B, pp. 31-32.) The Commissioner allocated the entire gain to Topeka, assigning Sec. 482 as his authority (App. B, p. 33), and the Tax Court, finding that the sale by Topeka to the Wherry corporations was made to avoid taxes (App. B, p. 64), sustained his action, as did the court below.

b. Each Wherry corporation owned a land lease on which it constructed housing for rent to military personnel, at two different air or military bases. (App. B, p. 46.) The loans made to finance the projects were guaranteed by the United States. (App. B, p. 28.) In 1957, the United States filed complaints in the appropriate district courts to condemn these properties. In the Texas district it deposited $2.00 as estimated just compensation, but increased the de-

posit by $337,998.00 on June 6, 1958. In the California district it deposited $782,053.00. (App. B, pp. 46-47.) The defendant corporations answered, putting the amount of just compensation in issue. (App. B, p. 47.) Trials of that issue occurred, and on January 21, 1960 a jury verdict was brought in in the California district, increasing the just compensation to $1,106,000. Judgment in accordance therewith was entered on June 23, 1960. (App. B, p. 51.) An appeal was taken and the judgment was affirmed on October 1, 1962. (App. B, p. 51.)

In the Texas district a jury verdict resulted in a judgment entered on August 7, 1962, which increased the just compensation to $1,700,000. That judgment was not appealed. (App. B, p. 51-52.)

In its complaints the United States asked for immediate possession, which it obtained. It then entered into so-called "three-party agreements" with the mortgage creditors under the debts it had guaranteed, undertaking to pay off the debts under their terms. (App. B, p. 48.) The Wherry corporations did not sign these agreements. (App. B, p. 49.)

Thereafter, on August 11, 1958, the four corporations adopted resolutions to dissolve, adopting plans of liquidadation. (App. B, p. 49.) Then, on August 19 and 20, 1958, they filed motions with the district courts to withdraw the funds deposited earlier by the United States, and orders permitting withdrawal were entered on August 20 and 25, 1968. The funds were actually withdrawn on August 27, 1958 and September 2, 1958. (App. B, p. 49.)

c. The income tax issues arising from these facts were, together with many other issues arising from other facts, taken to the Tax Court, which decided these issues adversely to the taxpayers. The Tax Court held that the "sale or exchange" in the condemnation occurred when title passed to the United States, which was on the filing of the

complaint, and that in consequence the corporations had adopted their plans of liquidation too late to enjoy the benefits of I.R.C. section 337, under which the gain would have been tax-free at the corporate level. (App. B, pp. 97-99.) On appeal, the Court of Appeals for the Tenth Circuit agreed with the Tax Court that section 337 did not apply for the reason given by the Tax Court. (App. A, p. 7.)

Both courts also held that gain from the sale arose when the United States assumed the mortgage indebtedness for which it had already been contingently liable as guarantor, notwithstanding that the amount of the just compensation remained contingent on the litigation not determined until years later. (App. A, p. 6; B, pp. 97-98.) The Court of Appeals disagreed with the Tax Court about the dates when this occurred, and with respect to one of the Wherry corporations remanded for additional findings and consideration on this point. (App. A, p. 6.) The effect of this disagreement is not to make section 337 applicable or otherwise to eliminate the tax to the corporations in some period, unless the remand proves to have this effect as to one of the four.

On the Topeka issue, the Tax Court held that the Commissioner correctly allocated the entire profit on the sales to Topeka, under section 482, notwithstanding the filing of consolidated returns. (App. B, p. 66.) It based this decision on its finding that the sale by Topeka to the Wherry corporations was dictated by motives of tax avoidance. (App. B, p. 64.) This aspect of the decision was affirmed by the Court of Appeals (App. A, pp. 10-12), which held that section 482 justified the allocation of the entire profit to one corporation in spite of the consolidated return regulations.

The Court of Appeals also affirmed other aspects of the Tax Court's decision which petitioners do not consider issues suitable for raising in a petition for certiorari.

REASONS FOR GRANTING THE WRIT

1. Section 337 of the Internal Revenue Code of 1954 is remedial legislation designed to create a single tax, at the shareholder level only, when a corporation dissolves and incident thereto its assets are sold. The immediate purpose of the legislation is to establish a procedure to avoid the close fact determinations (cf. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), and *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950)) required by the only procedure available under prior law. This purpose is fully explained in S. Rept. No. 1622, 83rd Cong., 2d Sess., pp. 48-49, 258-259, and in H. Rept. No. 1337, 83rd Cong., 2d Sess., pp. 38-39, A106-A107. As the House report stated (p. A106):

> ". . . . under present law, the tax consequences arising from sales made in the course of liquidation depend primarily upon the formal manner in which transactions are arranged. The possibility that double taxation may occur in such cases results in causing the problem to be a trap for the unwary."

The manner in which this remedial legislation is to be applied to dissolutions triggered by involuntary conversions is an important question of federal law which has not been but should be settled by this Court. As the courts below both recognized (App. A, p. 7; App. B, pp.97-98), section 337 is applicable to dispositions pursuant to involuntary conversions as well as to those pursuant to consensual transactions. *Towanda Textiles, Inc. v. United States*, 180 F. Supp. 373 (Ct. Cl., 1960); *United States v. Morton*, 387 F. 2d 441 (C.A. 8, 1968); *Kent Manufacturing Corp. v. Commissioner*, 288 F.2d 812 (C.A. 4, 1961); and dictum in *Covered Wagon, Inc. v. Commissioner*, 369 F.2d 629, 634 (C.A. 8, 1966). There are no cases to the contrary, and respondent conceded the rule below. See Rev. Rul. 59-108, 1959-1 Cum. Bull. 72, which so holds.

The courts have had difficulty in evolving a principle to decide when the "sale or exchange" occurs[4] in an involuntary conversion,[5] and have been unable to produce a consistent pattern. Thus they have held that in a condemnation the "sale or exchange" occurs when the government files notice of taking, if title passes to the government thereon. *Wendell v. Commissioner*, 326 F.2d 600 (C.A. 2, 1964); *Covered Wagon, Inc. v. Commissioner*, 369 F.2d 629 (C.A. 8, 1967) (alternate ground only); and the instant case.

But they have held that the "sale or exchange" does not occur when property is destroyed by insured fire or explosion. *Kent Manufacturing Corp. v. Commissioner*, 288 F.2d 812 (C.A. 4, 1961); *United States v. Morton*, 387 F.2d 441 (C.A. 8, 1968). Since title to destroyed property is not transferred, the courts were not distracted by the question when title passed and went to the purposes and intended function of section 337 to determine its meaning and effect.

The legislative history of section 337 shows that it was intended to eliminate the technicalities and emphasis on formalities of the prior law. See S. Rept. No. 1622 at pp. 48-49 and H. Rept. No. 1337 at pp. 38-39, cited above. Yet under prior law the formality of passage of title was not controlling. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1954). Congress could not have intended to eliminate formalities and technicalities and yet restore the importance of the one technicality which prior law accorded no weight.

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4. For section 337 to apply, a corporation must adopt a plan of liquidation before the "sale or exchange by it of (its) property" if its gain or loss on the sale is not to be recognized. In addition, the liquidation must be completed within 12 months of its beginning.

5. Involuntary conversions are treated as sales or exchanges. Int. Rev. Code of 1954, §§ 1033, 1231(a).

According transfer of title such weight as is accorded it below means that two taxpayers situated precisely alike in their general relationship to the United States Government will have differing tax liabilities because, e.g., one owned property condemned under New York law, where title passes on filing, and the other owned property in Missouri, where title does not pass until the award of compensation is made. See *United States v. Morton,* supra, 387 F.2d 441, where that analysis of the case law appears. Such differences should be irrelevant under section 337.

Such emphasis on the moment of passage of title seems improper for the further reason that it can extend indefinitely the twelve month period permitted by the statute, in consensual sales and exchanges. In voluntary contracts of sale the parties can advance or retard the passage of title as suits their purpose. Indeed, retention of title simply as a security device is common, and thus could postpone sales for section 337 purposes for 20 or 25 years. Recognition of the unsuitability of passage of title as a test is what prompted the Government to take the position it did and this Court to hold as it did in *Commissioner v. Court Holding Co.,* supra, 324 U.S. 331. If section 337 is interpreted to sanctify this formality, no consensual sale or exchange need ever occur prior to the adoption of a plan of liquidation.

Yet section 337 was not adopted to overrule this Court's decision in *Court Holding,* but instead to provide an alternative rule not dependent on difficult questions of fact. Where a corporation does not invoke the procedures of section 337, the *Court Holding* rule still governs. The legislative history of section 337 suggests an entire absence of purpose to extract any single formality and exhalt it to controlling effect. The Treasury Regulations make the same suggestion and provide for reference to all "the terms of the contract and the surrounding circumstances." Treas. Reg. 1.337-2(a).

Consistently with the remedial nature of section 337, the Treasury Regulations are liberal in instances of consensual sales, allowing the corporation a maximum opportunity to adopt a plan of liquidation before the "sale or exchange" will be deemed to have occurred. Treas. Reg. 1.337-2(a). They provide that "the fact that negotiations for sale may have been commenced, either by the corporation or its shareholders, or both shall be disregarded. Moreover, an executory contract to sell is to be distinguished from a contract of sale." In any analogy to consensual sales, the cases involving involuntary conversions from fire or explosion are correct and those involving involuntary conversions are wrong, since there is not even so much as an executory contract of sale where the price remains to be negotiated or fixed.

No reason is apparent why a treacherous and dangerous test should be applied to treat condemnees more harshly than victims of insured fires and explosions. The same element of surprise and lack of control of the involuntary conversion is present in each, and in each events ordinarily remove the opportunity of adopting a plan of liquidation before fate or the sovereign unilaterally acts. The rule the cases apply to fires and explosions can as easily be applied to condemnations: this rule is that the sale does not occur until the gain has been realized under standard tax concepts. This is essentially the rule the regulations apply to consensual sales. Its application to condemnations would relate section 337 to its purpose, which is to permit corporations to elect to dissolve before gain has been realized from the disposition of their principal asset, and to eliminate the tax at the corporate level if they do so.

Under normal tax rules, the gain here was not realized either when title passed or the United States assumed the

corporations' indebtedness.[6] The gain would not have been realized until the award was made. *Patrick McGuirl, Inc. v. Commissioner,* 74 F.2d 729 (C.A. 2, 1935), cert. den. 295 U.S. 748 (1935); *Nitterhouse v. United States,* 207 F.2d 618 (C.A. 3, 1953), cert. den. 347 U.S. 943 (1954), reh. den. 347 U.S. 970 (1954); *Commissioner v. Henry Hess Co.,* 210 F.2d 553 (C.A. 9, 1954). Conceivably some of it would have been realized when the court released the deposit to the condemnees, but this occurred after the plans of liquidation had been adopted and therefore would not affect us adversely under the rule for which we argue.

Accordingly, this case presents important questions under section 337 of the Internal Revenue Code of 1954 which this Court should decide not only to achieve equality of treatment in all types of involuntary conversions but to prevent adoption of an unsound rule extending to consensual contracts of sale.

2. The decision below, in holding that gain in a condemnation taking accrues to a dissolving corporation prior to the making of the award in a contested matter, conflicts specifically with *Commissioner v. Henry Hess Co.,* 210 F.2d 553 (C.A. 9, 1954), and generally with *Cold Metal Process Co. v. Commissioner,* 247 F.2d 864 (C.A. 6, 1957). It also conflicts in principle with decisions of this Court, exemplified by *United States v. Safety Car Heating Co.,* 297 U.S. 88 (1936), *Dixie Pine Co. v. Commissioner,* 320 U.S. 516 (1944), *Security Mills Co. v. Commissioner,* 321 U.S. 281 (1944), and *United States v. Consolidated Edison Co.,* 366 U.S. 380 (1961). This conflict is in an area where tax controveries proliferate. It should be resolved.

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6. The corporations took no part in that act, and could not have escaped continued liability to the United States had the ultimate award been low enough. Concerning the lenders, the United States had been liable from the outset, having guaranteed the debts. This aspect of the case is more fully analyzed under the second question presented, infra p. 11.

The conflict with *Henry Hess* is direct. In both cases the United States Government took title to privately owned property under its power of condemnation, in both cases it had possession, in both cases there was a dispute about just compensation, in both cases the owning corporation was on the accrual basis, and in both cases the corporation dissolved before the dispute about compensation was resolved. In *Henry Hess* the Court of Appeals for the Ninth Circuit held that in these circumstances the gain did not accrue to the corporation and was not taxable to it. The court below held to the contrary.

Cold Metal Process (supra, 247 F.2d 864), although it did not involve the accrual of gain arising from a condemnation, presented essentially the same issue and was decided by the Court of Appeals for the Sixth Circuit in accordance with *Henry Hess,* on which it relied.

The principle that neither contested income nor contested deductions accrue to an accrual basis taxpayer until the contest has been determined is firmly based on the decisions of this Court cited above. One of them (the *Safety Car Heating* case, 297 U.S. 88) involves the accrual of income, and the others involve deductions. Nothing this Court has said about the principle would distinguish between them. Indeed, the *Safety Car Heating* case, which involved income, can be said to be the parent of the doctrine.

The court below here considered itself free to disregard the established rule because the United States, in transactions to which the corporations were not parties, agreed with the mortgage creditors that it would be primarily liable for the mortgage debt. The court below read too much significance into this circumstance. The United States had been guarantor of the mortgage debt from its inception. When it seized the assets and cut the corporations

off from the rental income required to service the debt,[7] it automatically triggered its own liability to the creditors under its guaranty. Viewed in the light of these circumstances, its agreements with the creditors merely served to avoid acceleration of the balance due and preserve its right to pay the debt off in installments, by forestalling foreclosure on account of the condition its own conduct had brought about.

The agreements with the creditors made their garnishment of the corporations' claims against the United States unnecessary, assuming such garnishment lawful under the Assignment of Claims Act (31 U.S.C. 203). Obviously it served the purposes of the United States to make the agreements. They did not, however, serve to eliminate the corporations' liabilities, as principal debtors, to the United States, the guarantor. The accounting between the United States and the four Wherry corporations remained to be concluded in the court proceeding invoked by the United States in condemning the properties in which the just compensation remained to be determined. Not until 1962 did that occur. By that year the corporations had been dissolved and liquidated pursuant to section 337 liquidations begun on August 11, 1958 and timely concluded on August 8, 1959. Under *Henry Hess* no income could accrue to them after August 8, 1959, and under that same decision no gain could accrue to them while the award remained contingent on litigation.

Henry Hess and the instant case have another circumstance in common, not heretofore mentioned. In *Henry Hess* partial compensation was paid on account in 1943, the year after the corporate dissolution, and the remainder was paid

7. Other government regulations prohibited these corporations from engaging in any other business (Fed. Housing Admin. Regs., 24 C.F.R. 803.23).

in 1944. In the instant case, partial compensation was released by the district court to the corporations in August and September of 1958, after the steps to dissolve pursuant to section 337 had been initiated. In *Henry Hess* the significance of the payment on account was not decided because it occurred after the completion of the dissolution and presented no issue different from the final payment. In the instant case it presents no issue of significance either, since it was paid after the section 337 liquidation had been started. If, as we contend above, the earliest event which could possibly constitute the "sale" under section 337 is the first receipt of partial payment by the corporations, their receipt of that payment after their liquidation had begun but before it was complete gives no difficulty.

If it needs to be considered, however, there is a further important question raised by the receipt of part payment. Even though it was released by the court, the corporations' right to retain it depended on the size of the ultimate award. The corporations or their transferees might have had to repay it.[8] The obverse of that contingency prevented accrual in *United States v. Consolidated Edison Co.*, supra, 366 U.S. 380.[9] The question is whether a contingency which would prevent accrual of a deduction would also prevent

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8. The Capehart Act (42 U.S.C. 1594(a), 70 Stat. 1111-2, as amended by P.L. 85-104, 71 Stat. 303) as it stood in 1957 and 1958 provided that the release of the deposit was "without prejudice to any party to the proceeding." It thus retained the rule of *United States v. Miller*, 317 U.S. 369 (1942), where this Court allowed the Government to recover the portion of a released deposit in excess of the ultimate award. That rule is also stated in Rule 71A(j) of the Federal Rules of Civil Procedure.

The amount of the deposit has "no bearing whatsoever on value." *Chapman v. United States*, 169 F.2d 641, 644 (C.A. 10, 1948), cert. den. 335 U.S. 860 (1948).

9. The result of that case would not obtain today under I.R.C. section 461(f), but that code section involves deductions only, not the accrual of income. Nor would it apply to events in 1958 and 1959.

accrual of income. No reason in principle appears why it should not, and this Court has not distinguished between income and deductions in this respect. However, an earlier decision (*North American Oil v. Burnet,* 286 U.S. 417 (1932)) may be to the contrary, although there the Court expressly stated that the record was silent whether the taxpayer was on the accrual basis, and its statement that the accounting method employed was irrelevant related to the issue presented by an earlier year, not the year of contingent receipt.

Henry Hess was not called to the attention of the court below, but the decisions from this Court cited above were. It referred to them in its opinion (App. p. 7), without, however, perceiving their significance here.

In summary, there is a conflict between the decision below and that of another court of appeals in *Commissioner v. Henry Hess Co.*, 210 F.2d 553 (C.A. 9, 1954), which can be avoided only by concluding that some of the gain accrued when the partial payments were released to the corporations after their dissolution had begun. That conclusion, while avoiding the conflict, would lead to the further conclusion that the dissolution was timely under section 337. In that event the decision below would be wrong for the additional reason discussed above, which, as we have demonstrated, is also an appropriate one for review.

3. (a) The decision below should be reviewed for the further reason that it would establish a principle of wide application not heretofore found in the appellate cases, in a manner contrary to the code and regulations. It involves the improper resolution of a conflict between two code sections.

The shareholders of Honolulu Corp. were at all times the ultimate beneficial owners of Topeka, the four Wherry

corporations, and Honolulu Corp. They were required by Federal Housing Administration Regulations (24 C.F.R. 803.23) to place only Wherry housing activities and properties in the Wherry corporations. Those corporations had losses from the Wherry housing business and could under those regulations not embark on other businesses to produce offsetting income.

During the fiscal years ended in 1954, 1955, 1956, 1957 and 1958, Honolulu Corp. owned control of the Wherry corporations and also of Topeka, and filed a consolidated return for all of them and itself.[10] The privilege to do so permitted the Wherry corporations' losses to be offset against the income of other members of the consolidated group. In 1956 it appeared that Topeka's assets should be sold. They consisted of more than 400 houses near Topeka, Kansas. Topeka sold all of them to the Wherry corporations at a profit to itself of $882,967.39. The Wherry corporations then retailed the houses to the general public for an additional profit of $387,654.00, and applied this profit against their operating loss carryforwards. These transactions appeared in the Honolulu corporation's consolidated tax return, which included Topeka.

The Commissioner allocated the entire profit, both wholesale and retail, to Topeka, acting under the supposed authority of Internal Revenue Code section 482. However, neither Topeka nor the Wherry corporations had filed separate tax returns. Instead, their gross incomes and deductions were included in Honolulu corporation's consolidated return. The Treasury Regulations pertaining to consolidated returns are true legislative regulations,[11] and the election to file pursuant to them constitutes an accept-

10. Until February 10, 1958.

11. I.R.C. sections 1501, 1502.

ance of them. Treas. Reg. 1.1502-1A(a). Moreover, in the year in question the election to do so produced a two percent additional tax.

This two percent additional tax was paid for the privilege of freely having inter-consolidation transactions, including the right to pay intercompany dividends without further tax. In the years in question, the regulations so providing also contained this provision (Treas. Reg. 1.1502-31A(b):

> "(b) *Computations.* In the case of affiliated corporations which make, or are required to make, a consolidated return, and except as otherwise provided in the regulations under section 1502:
>
> (1) *Taxable income.* The taxable income of each corporation shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations, except:
>
> (i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in the regulations under section 1502 as intercompany transactions)...."

The consolidated return regulation thus eliminated all profit of Topeka on its sales to the Wherry corporations, whatever its amount, and allocated all of it to the Wherry corporations. The effect of what was done below was to reverse the effect of the regulation.

The decisions below were based on the supposed effect of section 482. Until this case it had been thought that the consolidated return regulations were the exclusive source of rules governing intercompany transactions where consolidated returns were filed. They contain many provisions in conflict with code sections of general application: viz., freedom of intercompany dividends from tax versus sections 61(a)(7) and 243(a) and carryover basis on intercompany sales versus section 1012. They contain no authoriza-

tion to apply section 482 so as to override the above regulation. The section 482 regulation relied on below (Treas. Reg. 1.482-1(b)(2)) can not be interpreted to override the consolidated return regulations.

The legislative history of section 482 shows it to be without application to consolidated returns. It first appeared in its present form as section 45 of the Revenue Act of 1928. The 1928 Act removed all provision for consolidated returns. Section 240 of the 1926 Act had permitted affiliated groups to file consolidated returns, and section 240(f) was the forerunner of section 45 (now section 482), but with significant differences. Section 240(f) permitted the Commissioner to "consolidate the accounts of . . . related trades or businesses," and required him to do so on the taxpayer's request. The new section was rewritten for the deliberate purpose of requiring allocation between taxpayers instead of consolidation of them. H. Rept. 2, 70th Cong., 1st Sess., pp. 16-17.

When the provision for consolidated returns was reintroduced by section 159 of the 1942 Act (amending section 141 of the 1939 Act to extend it to all corporations instead of merely railroad corporations), section 45 was left intact and unchanged. Clearly, then, it was thought not to provide for any type of consolidation.

(b) Moreover, section 482 was misapplied, assuming its applicability to consolidated returns, to an extent that could make it take over the roles Congress intended for sections 269 and 1551. The Tax Court found that the sale from Topeka to the four Wherry corporations was motivated by a desire to save taxes through applying some of the net operating loss carryovers of those corporations to the expected gain from the sale of Topeka's houses. It and the appellate court therefore applied a section 269 technique,

not a section 482 technique. The former would be to recreate the situation to what it would have been if no tax avoiding steps had occurred. The latter would be to allocate the income between Topeka and the four Wherry corporations, assigning the wholesale profit to Topeka and the retail profit to the four Wherry corporations. That was not done by the courts, although it was what the parties themselves had apparently attempted to do.

Section 269 could not have been applied. There are two conditions for its application, and neither was present. First, there was no shift in control. The transferor and transferees were all owned by the same common parent after the transfers as before, and section 269 is concerned with transfers accompanied by an acquisition of or shift in corporate control. Second, a new stepped-up basis in property resulted from its purchase by the four Wherry corporations, and the second concern of section 269 is transfers of property between corporations not theretofore commonly controlled where the transferor's basis carries over. These limitations on the application of section 269 will be rendered meaningless if section 482 can accomplish the same thing as section 269 does where it applies.

Congress also provided section 1551 to overcome certain types of tax avoidance by use of corporations. It, like section 269, is inapplicable here. The transferee corporations were already in business, so an essential condition of section 1551 is absent. The courts below simply avoided that limitation by allocating the income away because of the tax avoidance which would otherwise occur.

The Court of Appeals stated that this stretch of section 482 must be within the Congressional purpose because tax avoidance would otherwise result. (App. p. 12). What the court overlooked is that Congress deliberately wrote sec-

tions 381 and 382 so that the parties could have done the same thing by a merger of the four Wherry corporations into Topeka. Cf. *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (C.A. 9, 1965). Because there was no shift of beneficial interest, section 382 would not have provided for any dilution of the effect of the carryovers.

It is important that courts observe the limitations the statutes express on denying taxpayers the tax reductions Congress has seen fit to confer. So long as corporations are taxed differently than individuals, individuals will use the corporate form to lighten the tax load of their businesses. Congress is aware of this, and has not authorized a heavy handed undoing of corporate tax advantages wherever they are obtained consciously.

To apply section 482 as was done here is to undo what Congress has carefully wrought in writing the limitations found in sections 269 and 1551, and to transform section 482 into a weapon it was not designed to be.

Section 482 is a much older section than sections 269 and 1551, dating back in substantially its present form to section 45 of the Revenue Act of 1928. It does not depend for effectiveness upon a finding of a tax avoidance purpose, whereas sections 269 and 1551 do. Neither, unlike them, does it authorize allocating to one corporation all the income it took two to create. It speaks of "allocating" income "among" corporations, not all to one and none to others. This may be why Congress thought it would not do what sections 269 and 1551 do, and enacted the latter two.

This Court should review this decision to prevent the establishment of a precedent which will have the effect of undoing the limitations Congress has designedly placed in sections 269 and 1551.

CONCLUSION

The writ of certiorari should issue.

Respectfully submitted,

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(Appendix A Follows)

Appendices B, C and D appear in separate volume.

Appendix A

In the United States Court of Appeals
for the Tenth Circuit

Nos. 10060-10091

Likins-Foster Honolulu Corp., et al.,
Petitioners,

vs.

Commissioner of Internal Revenue,
Respondent.

Before PICKETT, HILL and HOLLOWAY, Circuit Judges.

PICKETT, Circuit Judge: Likins-Foster Honolulu Corporation and its shareholders petitioned for a review of adverse decisions of the Tax Court redetermining deficiencies against Honolulu and various wholly or partially owned subsidiaries and the shareholders thereof. The tax liabilities of 20 transferee shareholders are contingent upon the decision in the principal case. The Commissioner has cross-petitioned as to one of the issues in the principal case and in order to protect an alternate position, has cross-petitioned in 10 of the transferee cases.

The material facts giving rise to this controversy were stipulated by the parties or are not in dispute, and were the subject of extensive findings by the Tax Court. Four wholly-owned subsidiaries of Honolulu owned Wherry Act housing projects[1] which were condemned by the United States

1. See 12 U. S. C. § 1748 et seq. This court has previously had occasion to discuss the nature and operation of the "Wherry Act." *Sill Corporation v. United States*, 10 Cir., 343 F. 2d 411, *cert. denied*, 382 U. S. 840; *Buena Vista Homes, Inc., v. United States*, 10 Cir., 281 F. 2d 476.

pursuant to the provisions of the Capehart Act, 42 U. S. C. § 1594a, on October 30 and November 1, 1957. The projects were located at Biggs Air Force Base, Texas and Ft. Ord, California. The complaints and declarations of taking filed under 40 U. S. C. § 258a recited that the estate being taken consisted of all right, title and interest of the particular Wherry corporation "subject to the interest of" the mortgagees. The Wherries contested the proceedings only with regard to the issue of just compensation. In 1960 and 1962 judgments were entered on jury verdicts which were substantially in excess of the sum of money estimated to be just compensation for the property taken and deposited in court with the declaration of taking.

It was stipulated that subsequent to the dates of the filing of the condemnation complaints and the declarations of takings the Wherries made no further payments to the mortgagees on the notes secured by the condemned properties. Subsequent to the condemnation proceedings the United States entered into agreements with the mortgagees assuming the liabilities of the Wherries on the mortgages. These agreements recited that they were executed "as of December 27, 1957," as to Biggs and El Paso and "as of November 1, 1957" with respect to Ord and Monterey. The Wherry Corporations were not parties to these agreements and refused to sign supplemental agreements submitted by one of the mortgagees evidencing release of their liability as mortgagors.[2] For the fiscal years ending June 30, 1954 through June 30, 1957 Honolulu and its subsidiaries filed consolidated income tax returns. After February 10, 1958 Honolulu ceased

2. Counsel for the Wherries was of the opinion that his clients were protected by the agreements and that there was no need to execute separate documents of release. When the supplemental agreements were submitted counsel declined to execute them again because he believed his clients were protected and also because he believed signing the release might compromise his clients' position in the condemnation suits.

to hold 80% of the stock of Ord, Monterey, Biggs and El Paso and was no longer eligible to file consolidated returns with these subsidiaries. Each of these corporations filed separate returns for the period February 11, 1958 to June 30, 1958 and for the fiscal year ending June 30, 1959.

Following disclaimer by the mortgagees the Wherries withdrew the deposits pursuant to court order in August and September, 1958. In the fiscal years 1958 or 1959 neither the consolidation nor the subsidiaries in their separate returns reported any income resulting from the condemnations. The Commissioner determined that Honolulu and its subsidiaries had realized gain in the fiscal year ending June 30, 1958 in the amount of the excess of the mortgage principal outstanding as of the dates of condemnation over the depreciated cost basis of the Wherries in the properties condemned. The Tax Court sustained this determination and the taxpayers concede their liability, but dispute the date upon which their gain was realized. It is the position of the taxpayers that the United States took the properties as a whole and became liable for just compensation for the entire value of the respective projects without regard to the amount due on the mortgages, and that at the time of taking the United States was not liable for the payment of the mortgages. Consequently, it is said that because the taxpayers were entitled to be paid for the whole property the liability of the United States on the mortgages was not determined at the date of taking and the continued liability of the mortgagors affected their right to compensation. They support this position by a broad attack on the power of the United States to condemn the projects subject to the outstanding mortgages. This issue was not raised in the condemnation proceedings. The sole issue tried there was the amount of the compensation to be paid for the taking of the property. *Likins-Foster Monterey Corporation v. United States,* 9 Cir., 308 F.2d 595. While this may be a collateral

attack upon the condemnation judgment,[3] we are satisfied that by the enactment of the Capehart Act and supplemental legislation, 70 Stat. 682, Congress intended to authorize the United States to condemn Wherry Act projects and to take title to the owners interest therein subject to existing mortgages. *United States v. Certain Interests in Property, Etc.*, 7 Cir., 271 F.2d 379, *cert. denied*, 362 U. S. 974. The legislative history of the Act contains a summary of the procedure to be followed in determining the sponsor's interest and concludes: "To determine the value of the lessee's interest it would be necessary for the Commissioner to ascertain the difference between the purchase price as determined by him and the principal obligation (the Mortgage), plus accrued interest." In the following paragraph it is stated: "The Secretary of Defense would assume or purchase subject to the balance due under the insured note secured by the Mortgage on such housing and make all future payments thereon. 3 U. S. Code Cong. and Admin. News 1956, page 4552, 84th Cong., 2nd Session. See also the 1956 Amendments, 70 Stat. 1091 at 1112, indicating in the context of other types of condemnations that the measure of compensation is the difference between the outstanding principal obligation plus interest and the price of the property fixed by the court, and thus confirming that it is the equity in Wherry Act housing which is condemned.

We believe a reasonable interpretation of the Act to be that condemnation of the equities was authorized by the statutes, as was done in these cases. The takings were effected under the statutes on the filing of the declarations of taking and making of the deposits. 40 U. S. C. § 258a. As it was obligated to do in such circumstances, the Government thereafter made the mortgage payments. It also made

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3. The Commissioner has not questioned the jurisdiction of the Tax Court to consider this question. See *Commissioner v. Gooch Co.*, 320 U. S. 418; *Taylor v. Commissioner of Internal Revenue*, 2 Cir., 258 F. 2d 89.

the assumption agreements with the mortgagees, as mentioned above. By such assumption of the mortgages with the assent of the mortgagees the Government became directly and primarily liable to the mortgagees. *Fitzgerald v. Flanagan,* 155 Iowa 217, 135 N. W. 738; *Union Stove & Machine Works v. Caswell,* 48 Kan. 689, 29 P. 1072. Moreover, such procedure in no way prejudiced the rights of the mortgagors to just compensation for their interests and presented no Constitutional questions. We conclude that such takings of the equities were authorized by the statutes and not violative of the Fifth Amendment.

The law is settled that where mortgaged property is sold and the mortgagor's indebtedness is canceled by the assumption of the mortgage by a third party, the amount of gain realized by the seller is measured by the excess of the outstanding mortgage principal over the seller's basis in the mortgaged property. Int. Rev. Code of 1954, §§ 61(a)(12) and 1001; *Crane v. Commissioner,* 331 U. S. 1; *Commissioner v. Jacobson,* 336 U. S. 28. It is also accepted law that for capital gains purposes, involuntary conversions such as condemnations are treated as "sales or exchanges" under the statute. *Kieselbach v. Commissioner,* 317 U. S. 399; *Hawaiian Gas Products v. Commissioner of Int. Rev.,* 9 Cir., 126 F.2d 4, *cert. denied,* 317 U. S. 653. See 3B Mertens, Federal Income Taxation, § 22.100.

In the condemnation proceedings, as provided by 40 U. S. C. § 258a, title to the Wherry projects vested in the United States upon the filing of the declarations of taking and the payment into court of the estimated compensation. *Covered Wagon, Inc. v. C. I. R.,* 8 Cir., 369 F.2d 629; *Travis v. United States,* Ct. Cl., 287 F.2d 916, *cert. denied,* 368 U. S. 824. The nominal character of the initial deposits in the Texas condemnations did not delay the vesting of title in the United States. *United States v. Cobb,* 9 Cir., 328 F.2d 115. The date title vested in the United States is also the date the "sale or exchange" necessary for capital gains

treatment occurred. *Kieselbach v. Commissioner, supra; Covered Wagon, Inc. v. C. I. R., supra.* See 3B Mertens, *supra,* § 22.103.

Except as to Ord, which is discussed in the appendix hereto, we conclude that gains to the mortgagors in connection with the cancellation of their mortgage indebtedness occurred on the execution of the agreements by the Government to assume the mortgage obligations, together with the release of the mortgagors by the mortgagees. See *Riss v. C. I. R.,* 10 Cir., 368 F.2d 965, 968; *Newmark v. C. I. R.,* 2 Cir., 311 F.2d 913; *Clarke v. United States,* 94 F. Supp. 543, 548 (E. D. Pa.); and 2 Mertens, Federal Income Taxation, § 11.19. Although the right of the mortgagors to have the Government take over the mortgage obligations existed from the condemnation of the equities, there was no assumption of their mortgage obligations until the agreements were made and resulting gains to the mortgagors did not occur until there was an assmuption and a release of their obligations on the mortgages. See *Riss v. C. I. R., supra; cf. Nitterhouse v. United States,* 3 Cir., 207 F.2d 618, *cert. denied,* 347 U. S. 943. To this extent we disagree with the views of the Tax Court. We treat the details as to the effect of the agreements with respect to the four Wherry corporations in the appendix hereto and there discuss our determinations of the effective dates of the release of the mortgagors on the mortgages, taking into consideration the differences in the agreements. As to Ord, for reasons stated in the appendix, we conclude that the Tax Court on remand should consider the agreement and the surrounding facts and determine when there was an effective release and resultant gain. See *Cardwell Investment Co. v. United Supply and Manufacturing Co.,* 10 Cir., 268 F.2d 857, at 860.

The Wherry Corporations commenced liquidation on August 11, 1958 and terminated their existence on August 8, 1959. The taxpayers contend they were entitled to nonrecog-

nition of gain treatment provided by 26 U. S. C. § 337(a) with respect to gain realized on the withdrawal of deposits following the commencement of the liquidation. The Tax Court held that § 337 was not applicable because the properties had not been sold within 12 months following the adoption of their plans of liquidation. The taxpayers challenge this holding asserting that the "sale" required by § 337 was consummated after the adoption of the plan of liquidation when the amount of compensation was determined. Section 337 has no application here because the sale or exchange of the property occurred on the date of the taking by the United States in the condemnation proceedings. The courts have uniformly held that the necessary sale does not occur within 12 months of the adoption of a plan of liquidation where title to the condemned land had vested prior to adoption of the plan. *Covered Wagon, Inc. v. C. I. R., supra; Dwight v. United States,* 2 Cir. 328 F.2d 973; *Wendell v. C. I. R.,* 2 Cir., 326 F.2d 600, and cases cited therein; *Rev. R.* 59-108, 1 *Cum. Bul. 72; cf. West Street-Erie Boulevard Corp. v. United States,* N. D. N, Y.. 294 F. Supp. 145, aff'd in part (2 Cir.), — F.2d —; *Feinberg v. C. I. R.,* 8 Cir., 377 F.2d 21.[4]

Honolulu as parent of the consolidated group will become liable for the gain realized by the Wherry Corporations as a result of the condemnations in fiscal 1958. Int. Rev. Code of 1954, § 1552(a)(1) and (b); Treas. Regs. § 1.1502-30A.

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4. The taxpayers' reliance on *United States v. Morton,* 8 Cir., 387 F. 2d 441, is obviously misplaced. The Eighth Circuit held that where a plan of liquidation was adopted after a fire loss but before settlement of an insurance claim, the date of sale was the date of claim settlement rather than the date of the fire. The Court expressly adhered to its earlier decision in *Covered Wagon* with respect to an involuntary conversion by condemnation. In addition, the rationale of *Morton* turned on the fact that the amount to be received by way of reimbursement was unascertained prior to adoption of the plan of liquidation, whereas the amount of the deposits sought to be taxed in this case as capital gain was determined either on the date of condemnation or prior to the adoption of the plans of liquidation.

When the Wherries withdrew the escrow deposits in early fiscal 1959, the funds were credited on the books of Honolulu as "Gain on Sale of Assets" and thereafter were alternatively treated as either "liquidated dividends" or as a collection on the "chose-in-action" which the Honolulu Corporation was to receive as a result of liquidation. Honolulu now seeks to offset against the 1959 liquidating dividends its 1958 liability for the taxes owed by the Wherries by treating the Wherries liability as a retroactive account receivable, thereby substantially reducing its tax liability for the fiscal year ending 1959. The total tax liability of the consolidated group growing out of the condemnation of the Wherry projects was $605,794. The taxpayers assert that Honolulu, which must now pay the tax, may treat it as a retroactive account receivable and offset proportionately the amount of the liquidating dividend paid by each of the Wherries in August and September, 1958. The Tax Court held the liability of the Wherries for taxes would not accrue until the termination of this litigation in which liability is denied and cannot be reflected on Honolulu's 1959 tax return. In disposing of this issue we agree with the following statement of the Tax Court:

> "Petitioners argue that since Honolulu is not only liable as a transferee of its former subsidiaries but also because for some years prior to the fiscal year 1959 it filed consolidated returns with these affiliates, the holdings in *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), and *James Armour, Inc.*, 43 T. C. 295 (1964), are inapplicable. Any deficiencies in tax which may be determined when the decision of this Court is entered with respect to Monterey and other 'Wherry' corporations which Honolulu is required to pay are not a liability which is finally determined until the decision of this Court is entered. It was because such liability was not fixed or paid until a later year, and not merely because the liability was a transferee liability, that formed the

basis of the holding in *Arrowsmith v. Commissioner, supra,* and in *James Armour, Inc., supra,* that the deduction should be taken in the later year. Therefore under the holdings of these cases, Honolulu is not entitled to deduct any amounts of the liabilities of the 'Wherry' corporations which it may ultimately be called upon to pay until they are either finally determined or paid. In effect, Honolulu is attempting to obtain a deduction for the yet undetermined taxes of the 'Wherry' corporations which it may eventually be called upon to pay by reducing its gain from liquidating distributions from such corporations in the fiscal year 1959 by the yet undetermined amounts."

See also *U. S. v. Consolidated Edison Co.,* 366 U. S. 380; *Security Mills Co. v. Comm'r.,* 321 U. S. 281; *Dixie Pine Co. v. Commissioner,* 320 U. S. 516. The remedial provisions of 26 U.S.C. §§ 1311-1315 have no application.

Likins-Foster Topeka Corporation, a non-Wherry subsidiary, owned in excess of 400 houses in Topeka, Kansas which it rented to the personnel of Forbes Air Force Base. Topeka conveyed the separate units in this project to the four Wherry Corporations about July 1, 1956 and in turn each Wherry sold the parcels which had been deeded to it prior to the end of fiscal 1957. At the time of the transfer each of the Wherries had substantial operating carry-over losses. They took the property subject to existing F. H. A. mortgages but did not assume them. The consideration received by Topeka upon conveyance to the Wherries was substantially less than it would have received through sales to third parties. The Tax Court concluded that tax evasion purposes could be inferred from these transactions because the value of the property transferred to each Wherry was approximately equal to the amount of carryover available to each. Following sale of the houses by the Wherries and receipt of the downpayment and additional payments, the

Wherries, having realized a gain which caused them to have income, distributed the installment contracts of the purchasers to the parent corporation as dividends. The significance for tax purposes of this series of transactions is that the Wherries then had income for fiscal 1957 against which net operating loss carryovers could be offset. The Wherries' carryovers emanated from years for which each had filed separate returns, and would have expired if not utilized in the fiscal year ending June 30, 1957. Topeka, on the other hand, had no loss carryovers available to it, and because the Wherries' carry-overs were for years in which separate returns had been filed, the carry-overs were available only to the Wherries and were not otherwise available to the consolidation or other members thereof.[5] Pursuant to 26 U.S.C. § 482, the Commissioner reallocated the total gain from the sales ($472,841) as reported by the Wherries back to Topeka. The purpose of § 482 is to permit the Commissioner to distribute, apportion or allocate gross income, deductions, credits or allowance between organizations or businesses controlled by the same interests to prevent evasion of taxes or to clearly reflect the income of such organizations. *W. Braun Co. v. C. I. R.*, 2 Cir., 396 F.2d 264; *Eli Lilly and Company v. United States*, Ct. Cl., 372 F.2d 990; *Charles Town, Incorporated v. C. I. R.*, 4 Cir., 372 F.2d 415, *cert. denied*, 389 U. S. 841; *Spicer Theatres, Inc. v. C. I. R.*, 6 Cir., 346 F.2d 704. The Commissioner contends that the Wherries were used only as conduits for the disposition of Topeka's assets in order that the consolidation might receive the benefits of the Wherries' loss carry-overs.

The Tax Court found a tax avoidance purpose and concluded that the Commissioner had the power under § 482 to

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5. Under the consolidated regulations, net operating loss carryovers from separate return years are available to a consolidation only as offsets against the income of the affiliate which actually experienced the preconsolidation loss. Treas. Regs., § 1.1502-31A(b)(3); see *Phinney v. Houston Oil Field Material Company* 5 Cir., 252 F. 2d 357.

reallocate the income to Topeka. Taxpayers do not deny a tax avoidance motive, but argue that it is irrelevant since § 482 does not apply to intercompany transactions between consolidated groups which are governed solely by § 1501 et seq. It is argued that the income to be reflected in a consolidated return is the income computed under the consolidation sections; that since the Commissioner has ruled that transfers between components of a consolidation are not transfers resulting in gain or loss, there is no income to be allocated under § 482. The Government counters urging that since the regulations, § 1.482.1(b)(2), providing that § 482 applies in the case of any controlled taxpayer, "whether such taxpayer makes a separate or a consolidated return", have been continued without change through several reenactments of the I. R. C., the regulations are deemed to have been given Congressional approval.[6]

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6. Section 1.482-1(b) is as follows:

"(1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

"(2) Section 482 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidatel taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return."

Aside from the various legal niceties, it seems apparent that the taxpayer should not be allowed to prevail on the basis of form over substance. It is true that 26 U. S. C. 1501 et seq. governs consolidated returns. However, § 1502 expressly delegates power to promulgate regulations to assure a proper reflection of income. One of those regulations—which is not challenged by the taxpayer—provides that preconsolidation loss carry-overs can be offset only against the specific affiliate that incurred the loss. Whether this is accomplished by a direct transfer of loss carry-overs from the loss corporation to the consolidation to offset the group's income (specifically prohibited and recognized as prohibited by the taxpayers) or whether this is accomplished by transferring group income to the loss corporation (the method employed here) should make little difference. In either case, the result works the same tax distortion and cannot be sustained.

The final issue raised here arises out of a cross-appeal by the Commissioner from an adverse decision of the Tax Court concerning distributions during the fiscal year 1956 to Honolulu by two of its subsidiaries which distributions were in excess of Honolulu's basis in the stock of the distributing corporations.[7] At the time of the distributions, the subsidiaries making the distributions had no earnings or profits. Consequently, payments were not dividends as defined by 26 U. S. C. 316(a). Non-dividend distributions "shall be applied against and reduce the adjusted basis of the stock." 26 U. S. C. 301(c)(2). The difficulty arises here because the parent had already received the amount of its basis in the stock. The Tax Court concluded that although the distributions were not dividends, they were "intercompany transactions" under Treasury Regulations 1.1502-31A

7. It is without dispute that the distributions were with respect to stock as provided by § 301(a), I. R. C. 1954, and that § 301(c) applies in the absence of a controlling provision of the consolidated regulations.

(b)(2)(iii)(a) and eliminated from income of the parent corporation which received it for the purpose of making a consolidated return. The Commissioner's contention is that the distributions in excess of Honolulu's basis in the stock of the subsidiaries are taxable under § 301(c)(3)[8] and that the consolidated return regulations do not provide for their elimination from income. It is argued that because of the permanent tax avoidance resulting from the Tax Court's decision the regulations relating to treatment of capital gain in intercompany transactions should not be applied. Specifically, the Commissioner contends that no carry-over basis existed which would reflect gain upon the sale of the property to an outsider.[9] The Tax Court was of the opinion that there was only a possibility that the distributions had or would escape taxation. In this connection the Court said:

> "Expressed another way, to the extent that the cash which was distributed to the parent was accumulated by the subsidiaries during consolidated years, it very likely has in some way been taxed as an overall part of the consolidation. The fact that respondent in connection with redemption of stock issued a specific regulation which we will subsequently discuss, does not justify reaching a conclusion specifically contrary to another portion of his regulations where he has not chosen to change those regulations."

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8. 26 U. S. C. 301(c)(3) is as follows:
"Amount in excess of basis.—(A) In general.—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property."

9. It appears that the Commissioner's new regulation treating this subject, § 1.1502-14(a)(2), would postpone recognition of the income resulting from non-dividend distribution by recording it in an "excess loss account" which is applied to the parent's income when the stock in the subsidiary is sold, or when the affiliation of the subsidiary with the consolidated group is terminated. §1.1502-19(a) and (b).

Relying on *American Water Works Co. v. Commissioner of Int. Rev.*, 2 Cir., 243 F.2d 550, the Court also concluded that the reduction in basis of the stock of the subsidiaries in the hands of the parent prevented tax avoidance. It is recognized that the Commissioner's treatment would be correct in the normal non-consolidation situation. However, the consolidation sections provide for non-recognition of gain on intercompany transactions:

> "There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another. . . ." (§ 1.1502-31A(b)(1)(i))

Thus, the Tax Court holding that the regulations expressly eliminated capital gain transactions between affiliates must be upheld.

The decision of the Tax Court in these consolidated cases is modified as stated herein and the cases are remanded for further proceedings and recomputation of the tax liabilities involved in accordance with this opinion and the appendix thereto.

Appendix

The four Wherry corporations involved were Monterey, Biggs, El Paso and Ord. Separate three-party agreements were executed pertaining to the obligations of each on its note and mortgage. They were executed by the military department involved, the Federal Housing Administration and the bank or insurance company holding the mortgage. These agreements will be considered separately.

Monterey: The agreement recites that it was entered into as of November 1, 1957. However, it was acknowledged by the Assistant Commissioner for Operations of the Federal Housing Administration on July 8, 1958. The agreement contemplated executed by three interested parties. We

conclude that the assumption and release agreement was effective for the purposes of this case on July 8, 1958, the completion of its execution. See *Kent Homes, Inc. v. United States,* 279 F. Supp. 650, 655 (D. Kan. 1967).

The agreement provided that the Government assumed the obligations of the note and mortgage. It also stated that the parties agreed that the mortgagor was released from all further liability and obligation on the note and mortgage. For tax purposes we conclude that the gain of Monterey in connection with the discharge of the mortgage indebtedness occurred on July 8, 1958.

Biggs and El Paso: Except for an immaterial difference in dates that may exist in the last acknowledgment, the two separate agreements relating to Biggs and El Paso read alike. The acknowledgment by the Assistant Commissioner for Operations of the Federal Housing Administration was made in January, 1958, for both agreements, the exact date being illegible. We conclude that the agreements relating to Biggs and El Paso were effective for tax purposes in January, 1958, the completion of their execution.

The agreements both contained the following provision, with a difference in amount of the omitted indebtedness being stated in each:

> "... *ARTICLE I*
> ASSUMPTION AND RELEASE AGREEMENT
>
> It is agreed by the parties hereto that the Department assumes the obligation of and will make the payments called for under the terms and provisions of the mortgage and note hereinbefore referred to and the Mortgagee agrees to accept the obligation of the Department to make such payments and the mortgagee and the Department hereby agree that the unpaid principal balance of said mortgage note on the day immediately preceding the effective date of this agreement is $..... The Department and the Commissioner

agree that, without affecting liability of the Department under the foregoing assumption, the Mortgagee may release Likins Foster . . . Corporation, the original mortgagor, from all liability in connection with the said note and the mortgage and chattel mortgage securing the payment of said note . . ."

We note that the mortgagee agrees to accept the obligation of the Government and the indication of intent to release the mortgagors in the caption of the article as well. While there is not the clear release as there was to Monterey, we believe a release of the mortgagors was intended. On the basis of Article I and the entire agreements we conclude that they effected an assumption of the mortgage indebtedness of Biggs and El Paso by the Government and a release by the mortgagee of their personal liability on the notes. We conclude that the gains of Biggs and El Paso in connection with the discharge of their mortgage indebtedness occurred in January, 1958.

Ord: In the case of Ord the significant provision of the three-party agreement reads as follows:

"*. . . ARTICLE II*

ASSUMPTION AND RELEASE

That the Department does hereby assume the obligation of, and will make the payments prescribed by and in accordance with terms and provisions of, said deed of trust and the note secured thereby relating to principal, interest, and mortgage insurance premiums (beginning with the payment due November 1, 1957); that the Mortgagee and the Commissioner do hereby accept the obligation of the Department to make such payments. This undertaking by the Department shall be without prejudice to the Government's position in said condemnation proceeding with respect to the pro-rating of such payment obligation with the mortgagor for any

period during which any payment or part thereof is allocable to any period prior to the date of the filing of the Declaration of Taking . . ."*

In view of the deleted language concerning the release of the mortgagor, Ord, we doubt that we should now hold as a matter of law that the agreement alone released Ord. We feel instead that we should leave this determination to be made first by the Tax Court on remand. There, the agreement and all the facts may be considered and the determination made from the record as to when an effective release of Ord by the mortgagee occurred, and thus, when a gain by discharge of the mortgage indebtedness may have resulted. See *Cardwell Investment Co. v. United Supply and Manufacturing Co.*, 10 Cir., 268 F.2d 857, at 860. In this connection we note that when the liquidation resolution of the corporation was adopted on August 11, 1958, the minutes recognized that the corporation had been relieved of its mortgage indebtedness by the three-party agreement. At least by this date the record shows that there was a course of conduct and mutual understanding between the parties to justfy an inference that the obligation of the mortgagors had been extinguished. The mortgagee had agreed to the assumption of the mortgage by the United States, accepted the mortgage payments from it, and did not object to the liquidation of Ord.

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*The deleted language reads as follows:

". . . and that the Department, the Commissioner, and the Mortgagee do hereby agree that the aforesaid mortgagor is released from all further liability and obligation under said mortgage and the note secured thereby . . ."

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No. 1087

In the Supreme Court of the United States

OCTOBER TERM, 1969

LIKINS-FOSTER HONOLULU CORP., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 1037

LIKINS-FOSTER HONOLULU CORP., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinions of the Tax Court (Pet. Apps. B and C) are not officially reported. The opinion of the court of appeals (Pet. App. A) is reported at 417 F. 2d 285.

JURISDICTION

The judgment of the court of appeals was entered on November 16, 1969 (Pet. 2). The petition for a writ of certiorari was filed on January 5, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the courts below correctly held that gains realized by certain of the petitioner corporations (the "Wherry" corporations) from the condemnation sales of their mortgaged properties to the United States did not qualify for nonrecognition under Section 337 of the Internal Revenue Code of 1954, because the sales occurred when title and possession passed to the United States, which was prior to the Wherry corporations' adoption of plans of liquidation.

2. Whether the Commissioner abused his discretion under Section 482 of the Internal Revenue Code of 1954 in allocating gain realized on the sale of houses from the corporations which purportedly sold the houses and reported the gain, to a commonly controlled corporation which had constructed the houses, where all of the corporations were part of a consolidated group and the construction corporation transferred the properties to the selling corporations solely for the purpose of providing the latter with current income to be offset against operating loss carryovers which could not otherwise be used.

STATUTES AND REGULATIONS INVOLVED

Pertinent statutory provisions are set forth in Appendix D to the petition. Additional statutory provisions and pertinent Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix, *infra,* pp. 17–21.

STATEMENT

Petitioners are a parent corporation, Likins-Foster Honolulu Corporation ("Honolulu"), various of its wholly or partially owned subsidiaries, and the shareholders of these corporations.[1] The corporations directly affected by the questions presented by this petition are four Wherry corporation subsidiaries,[2] and another subsidiary, Likins-Foster Topeka Corporation ("Topeka").[3] The tax years in issue are fiscal years ended June 30, 1957, 1958, and 1959. During those fiscal years and until February 10, 1958, these corporations were members of a consolidated group for tax purposes. After that date, the four Wherry corporations ceased to be members of the consolidated group. (Pet. App. B 18.)

I

The Wherry Act housing projects of the four Wherry corporations were condemned by the United States on October 30 and November 1, 1957, pursuant

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[1] The relationships between the parties were set out in detail by the Tax Court (Pet. App. B 25–28).

[2] They are: Likins-Foster Ord Corporation ("Ord"); Likins-Foster Monterey Corporation ("Monterey"); Likins-Foster Biggs Corporation ("Biggs"); Likins-Foster El Paso Corporation ("El Paso"). Each Wherry corporation entered into a contract with the Secretary of the Army pursuant to the so-called Wherry Act (Act of August 8, 1949, c. 403, 63 Stat. 570, Sec. 1 (12 U.S.C. 1748 *et seq.*)), whereby it leased land and constructed housing for rent to military personnel (Ord and Monterey in California; Biggs and El Paso in Texas). (Pet. App. B 46.)

[3] Topeka constructed and owned 421 houses and duplexes in Topeka, Kansas, which it rented to personnel at Forbes Air Force Base (Pet. App. B 28–29).

to the provisions of the so-called Capehart Housing Act (Housing Amendments of 1955, c. 783, 69 Stat. 635, Sec. 404 (b) as amended by Sec. 512, Housing Act of 1956, c. 1029, 70 Stat. 1091 (42 U.S.C. 1594a (b)).[4] The condemnation proceedings were initiated by the filing of declarations of taking and the deposit of the estimated compensation for the properties in the appropriate district courts in Texas and California pursuant to Section 1 of the Act of February 26, 1931, c. 307, 46 Stat. 1421 (40 U.S.C. 258a). The declarations of taking recited that the properties being taken consisted of all right, title and interest of the Wherry corporations "subject to the interest of" the mortgagees. The Wherry corporations contested the proceedings only with regard to the issue of just compensation. (Pet. App. B 46–47.)

The United States then entered into agreements with the mortgagees assuming the liabilities of the Wherry corporations on their mortgages (Pet. App. B 48–49). On August 27, 1958, and September 2, 1958, the Wherry corporations requested and received the funds which had been deposited by the United States in the district courts as estimated compensation for the taking (Pet. App. B 49). On August 11, 1958, each of the Wherry corporations had adopted a plan of liquidation (Pet. App. B 49). They completed the liquidations on August 8, 1959 (Pet. App. B 97).

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[4] The Capehart Housing Act, as amended, provided for housing to be built by the federal government and the purchase of Wherry housing at military installations where Capehart housing was to be built.

The Tax Court upheld the Commissioner's determination that, in fiscal 1958 when the properties were taken, each Wherry corporation realized gain from the condemnation sale in the amount of the excess of the principal amount of the mortgage liability assumed over the cost basis (Pet. App. B 94–95). The Tax Court further held that the condemnation sales occurred when the declarations of taking were filed and title vested in the United States. Since the declarations were filed prior to the adoption of the plans of liquidation, the Tax Court concluded that the nonrecognition-of-gain provisions of Section 337 of the Internal Revenue Code of 1954 did not apply (Pet. App. B 98–99). The court of appeals held that the condemnation sales occurred and the gains thereon were realized when the United States assumed the mortgages by agreement with the mortgagees, which also preceded adoption of the liquidation plans, and accordingly affirmed the Tax Court's holding that Section 337 was inapplicable (Pet App. A 6–7, 14–17).

II

During the fiscal year ended June 30, 1957, Topeka conveyed some of the houses it had constructed to the four Wherry corporations and they, in turn, immediately resold the properties to the public. Topeka's books showed that the price paid by the Wherry corporations exceeded Topeka's basis by $882,968 (Pet. App. B 29). The books of the Wherry corporations disclosed that they resold the properties for $387,654 in excess of the amount paid by them to Topeka (Pet.

App. B 31). Since Topeka and the Wherry corporations were part of a consolidated group, Topeka reported no gain from its transactions with the Wherry corporations (Pet. App. B 30). The Wherry corporations reported their sales on an installment basis and reported a gain of $472,841 for the fiscal year ended June 30, 1957 (Pet. App. B 31).

The Wherry corporations had preconsolidation net operating loss carryovers which could only be set off against their income and not against the income of other members of the consolidated group. Treasury Regulations 1.1502–31A(b)(3)(i). Topeka had no net operating loss carryover. The transactions were arranged so that the preconsolidation net operating loss of each Wherry corporation could be set off in full against the gain from the sales of the houses (Pet. App. B 31–32).

Exercising the allocation powers delegated to him by Section 482 of the Internal Revenue Code of 1954, the Commissioner determined that the gains reported by the subsidiary Wherry corporations from sales of the houses to the public were taxable to the commonly controlled subsidiary Topeka, which had constructed the houses for sale, but which, for the purpose of reducing tax liability transferred them to the Wherry corporations for purposes of sale. The Tax Court sustained the Commissioner's determination (Pet. App. B 60–66), and the court of appeals affirmed (Pet. App. A 9–12).

ARGUMENT

The court below correctly affirmed the Tax Court's determination of the issues raised by petitioners' appeals. There is no conflict, nor any other reason for further review by this Court.

1. Section 337 of the Internal Revenue Code of 1954 lays down several conditions precedent to nonrecognition of gain realized upon a liquidation sale of corporate assets, including the requirement that the sale occur within 12 months after adoption of a plan of complete liquidation. In holding that the gains realized by the Wherry corporations from the condemnation sales of their properties were not entitled to the nonrecognition-of-gain benefits of Section 337, because the sales took place prior to adoption of the plans of liquidation, the courts below reached the only decision compatible with the language of that section and the relevant decisions.[5]

The condemnation proceedings in the instant case were conducted pursuant to Section 1 of the Act of February 26, 1931, c. 307, 46 Stat. 1421 (40 U.S.C. 258a), Appendix, *infra*, pp. 17–19. That section provides

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[5] There is no dispute as to the amount of gain in question, or as to whether the condemnation proceedings resulted in a "sale" within the meaning of Section 337. It is settled that where mortgaged property is sold and the purchaser assumes (or takes subject to) the mortgage, the amount of gain "realized" by the seller includes the excess of the mortgage principal over the seller's basis in the mortgaged property. *Crane* v. *Commissioner*, 331 U.S. 1. It is also settled that involuntary conversions such as condemnations are "sales or exchanges" within the purview of Section 337. See, *e.g.*, *Covered Wagon, Inc.* v. *Commissioner*, 369 F. 2d 629 (C.A. 8), and cases there cited.

that title vests in the United States at the time of filing the declaration of taking and the deposit of estimated compensation in the district court, and that the right to compensation vests immediately, with a right to 6 percent interest on the amount by which the final award exceeds the deposit. In this case, the United States obtained not only title but immediate possession of the properties involved. (Pet. App. B 94–95.) Since title and possession had been conveyed and the right to compensation had vested in October and November, 1957—and the liquidation plans were not adopted until August, 1958—petitioners were not entitled to the benefit of Section 337. The courts have uniformly held that, for purposes of Section 337, the "sale" in a condemnation proceeding is deemed to have taken place not later than the vesting of title in the taking authority and the simultaneous vesting of the right to compensation. See, *e.g., Covered Wagon, Inc.* v. *Commissioner,* 369 F. 2d 629 (C.A. 8), which also involved a condemnation pursuant to Section 1 of the Act of February 26, 1931, *supra; Dwight* v. *United States,* 328 F. 2d 973 (C.A. 2); *Wendell* v. *Commissioner,* 326 F. 2d 600 (C.A. 2); *Wood Harmon Corp.* v. *United States,* 206 F. Supp. 773 (S.D. N.Y.), affirmed on another issue, 311 F. 2d 918 (C.A. 2); *Towanda Textiles, Inc.* v. *United States,* 180 F. Supp. 373 (Ct. Cl.); *Travis* v. *United States,* 287 F. 2d 916 (Ct. Cl.), certiorari denied, 368 U.S. 824.[6]

[6] It is true, as petitioners point out (Pet. 9), that the time of vesting of title under state condemnation laws varies from state to state, and that Section 337, which turns on when a sale occurs, might be available in connection with some state condemnations.

Petitioners' reliance (Pet. 8) upon *United States* v. *Morton*, 387 F. 2d 441 (C.A. 8), and similar cases involving destruction of insured property, is misplaced. *Morton* was decided by the Eighth Circuit, the same court which decided *Covered Wagon, supra*; as the court below pointed out (Pet. App. A 7), *Morton* did not involve a condemnation sale, and the Eighth Circuit there expressly adhered to its decision in *Covered Wagon*, which did involve a condemnation sale, as does the instant case. Moreover, as the court below also observed (*id.*, p. 7), the *Morton* decision turned on the fact that the amount received from the insurance company as reimbursement for the fire loss there involved, was unascertainable prior to adoption of the plan of liquidation, "whereas the amount of the deposits sought to be taxed in this case as capital gain was determined either on the date of condemnation or prior to the adoption of the plans of liquidation."[7]

But the condemnation sales here involved took place pursuant to a federal statute. See *Covered Wagon, Inc.* v. *Commissioner, supra*. Moreover, where property rights are involved, it is not unusual for the incidents of federal taxation to turn on local law. *Fernandez* v. *Wiener*, 326 U.S. 340, 359–360.

[7] Even if petitioners had no opportunity to adopt a liquidation plan prior to the condemnation sale, they would not have been entitled to the benefit of Section 337. As the Second Circuit noted in *Dwight* v. *United States*, *supra*, where the taxpayer had no advance notice of the condemnation (p. 974): "Hence the corporation had no opportunity to adopt a plan of liquidation before condemnation, and the conditions of section 337 could not be met. This may appear a harsh result, but if it is to be corrected Congress must act; the courts have no power to do so." A fortiori, petitioners are not entitled to the benefit of Section 337 where, as here, the government had a duty to negotiate with

2. Petitioners' contention (Pet. 11–15) that the recognizable gains from the condemnation sales did not "accrue" (and hence were not "realized") in the year of sale, but in a later taxable year not before the Court, was not advanced in the court below.[8] Having failed to raise the issue in the court below, petitioners may not do so in the petition for certiorari. *Zellerbach Co.* v. *Helvering*, 293 U.S. 172, 182; *Lawn* v. *United States*, 355 U.S. 339, 362, n. 16; *Duignan* v. *United States*, 274 U.S. 195, 200; *Helvering* v. *Wood*, 309 U.S. 344, 349. Indeed, petitioners acknowledge (Pet. 15), as they must, that the lone case with which they allege direct conflict in this connection (*Commissioner* v. *Henry Hess Co.*, 210 F. 2d 553 (C.A. 9)) "was not called to the attention of the court below," and accordingly was not considered or even mentioned by that court. In any event, *Hess* presented a situation quite different from that here presented. The question in *Hess* was whether an accrual basis corporation was taxable on gain from the requisition of its property, notwithstanding that the gain accrued in a year after the corporation had been dissolved and ceased to exist. No such question is here presented, since the Wherry corporations were still in existence

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them prior to instituting the condemnation proceedings. See Housing Amendments of 1955, c. 783, 69 Stat. 635, Sec. 404, as amended (42 U.S.C. 1594a(c)), Appendix, *infra*, pp. 19–20.

[8] Petitioners contended below that the gains were not realized in the year title and possession passed to the United States and the mortgages were assumed, on grounds other than that now urged in the petition. These grounds were properly rejected (Pet. App. A 3–6; Pet. App. B 96–99) and are no longer urged here.

when the gains from the condemnation sales accrued. Nothing in the *Hess* opinion warrants petitioners' assumption (Pet. 13) that gain from a condemnation sale cannot accrue prior to final payment of the condemnation award.

As for the other cases with which petitioners assert conflict "in principle" (Pet. 11), they were cited by the court below (Pet. App. A 8–9) in rejecting petitioners' argument on an entirely distinct issue—not raised in their petition—namely, whether Honolulu, parent of the Wherry corporations and transferee of their assets upon their liquidation, was entitled to deduct contested tax liabilities in the year of the liquidation. The courts below correctly held that these tax liabilities did not "accrue" until the contest was terminated, and petitioners do not challenge that holding here. Insofar as accrual of gain from a condemnation sale is concerned, *Covered Wagon, supra,* is directly in point. It was there held that the gain accrues in the year when the government takes title and makes a deposit, even though final payment of the compensation is made in a later year.

3. Section 482 of the Internal Revenue Code of 1954 vests in the Commissioner broad authority to allocate gross income and deductions among commonly controlled organizations if such allocation "is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organization * * *." It is settled that Section 482 empowers the Commissioner to scrutinize closely transactions between commonly controlled corporations in order to determine whether

such transactions would have been entered into in arm's length negotiations between strangers, and to allocate income or deductions between the controlled corporations if they fail to meet that standard, and that the Commissioner's exercise of the discretion delegated to him by Congress in that section should not be disturbed unless plainly arbitrary or unreasonable. See, *e.g., Local Finance Corp.* v. *Commissioner*, 407 F. 2d 629 (C.A. 7), No. 561, this Term, certiorari denied, December 8, 1969, and cases there cited; Treasury Regulations 1.482–1(b)(1).

The courts below correctly sustained the Commissioner's determination, pursuant to Section 482, that the gains reported in the consolidated returns by the Wherry corporations from sales of houses to the public were taxable to another subsidiary of Honolulu (Topeka) which had constructed the houses for sale, but which for purposes of tax reduction (carryover of separate net operating losses not otherwise usable on the consolidated return), first purportedly "sold" the houses to the Wherry corporations for immediate resale to the public. This was done in a year when all of the corporations participated in a consolidated return. The evidence shows, as both courts below found (Pet. App. A 9–11; Pet. App. B 60–66), that the purpose of the intercompany transfers was to provide the transferees with income against which they could offset operating loss carryovers not otherwise available to the consolidated group because they were sustained in preconsolidation years in which the transferee-loss cor-

porations had filed separate returns. On the basis of that evidence, the Commissioner was fully justified in allocating the gain from the Wherry corporations to Topeka.

There is no merit in petitioners' contention (Pet. 17–18) that Section 482 does not apply to taxpayers who participate in filing a consolidated return. The longstanding Treasury Regulations under Section 482 (Section 1.482–1(b)(2), Appendix, *infra,* p. 20) specifically provide that Section 482 and the regulations under it "apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return." This Court has "many times declared that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons." *Commissioner* v. *South Texas Co.,* 333 U.S. 496, 501. Furthermore, the regulation in issue comes within "the settled principle that 'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law' ". *United States* v. *Correll,* 389 U.S. 299, 305–306, quoting from *Helvering* v. *Winmill,* 305 U.S. 79, 83. See also *Lykes* v. *United States,* 343

U.S. 118, 129.[9] If any doubt otherwise existed regarding the applicability of Section 482 to taxpayers filing consolidated returns, it is dispelled by Code Section 1505, which, in enumerating cross-references relevant to the consolidated return sections, specifically refers to Section 482. See also Treasury Regulation 1.1502–80; Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed. 1966), p. 695.

Petitioners' alternative contentions (Pet. 18–20) that Code Sections 269 and 1551[10] are inapplicable are addressed to straw issues. The Commissioner's determination that the gains attributed to the Wherry corporations in the consolidated return were earned by and taxable to Topeka was made pursuant to the allocation powers vested in him by Section 482, not by virtue of the provisions of Section 269 or Section 1551.

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[9] Treasury Regulation 1.482–1(b)(2) originally appeared as Treasury Regulations 86, Art. 45–1(b) under the Revenue Act of 1934 which provided, as do the present Regulations, that "Section 45 [of the Revenue Act of 1934—the original predecessor of Section 482] and this article apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return."

[10] In the court below petitioners did not rely on Section 1551, but on Section 382(b)(3).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954:

Sec. 1505. Cross References.

(1) For suspension of running of statute of limitations when notice in respect of a deficiency is mailed to one corporation, see section 6503(a)(1).

(2) For allocation and deductions of related trades or businesses, see section 482.

[26 U.S.C. 1505.]

Act of February 26, 1931, c. 307, 46 Stat. 1421, Section 1:

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That in any proceeding in any court of the United States outside of the District of Columbia which has been or may be instituted by and in the name of and under the authority of the United States for the acquisition of any land or easement or right of way in land for the public use, the petitioner may file in the cause, with the petition or at any time before judgment, a declaration of taking signed by the authority empowered by law to acquire the lands described in the petition, declaring that said lands are thereby taken for the use of the United States. Said declaration of taking shall contain or have annexed thereto—

(1) A statement of the authority under which and the public use for which said lands are taken.

(2) A description of the lands taken sufficient for the identification thereof.

(3) A statement of the estate or interest in said lands taken for said public use.

(4) A plan showing the lands taken.

(5) A statement of the sum of money estimated by said acquiring authority to be just compensation for the land taken.

Upon the filing said declaration of taking and of the deposit in the court, to the use of the persons entitled thereto, of the amount of the estimated compensation stated in said declaration, title to the said lands in fee simple absolute, or such less estate or interest therein as is specified in said declaration, shall vest in the United States of America, and said lands shall be deemed to be condemned and taken for the use of the United States, and the right to just compensation for the same shall vest in the persons entitled thereto; and said compensation shall be ascertained and awarded in said proceeding and established by judgment therein, and the said judgment shall include, as part of the just compensation awarded, interest at the rate of 6 per centum per annum on the amount finally awarded as the value of the property as of the date of taking, from said date to the date of payment; but interest shall not be allowed on so much thereof as shall have been paid into the court. No sum so paid into the court shall be charged with commissions or poundage.

Upon the application of the parties in interest, the court may order that the money deposited in the court, or any part thereof, be paid forthwith for or on account of the just compensation to be awarded in said proceeding. If the compensation finally awarded in respect of said lands, or any parcel thereof, shall exceed the amount of the money so received by any person entitled, the court shall enter judgment against the United States for the amount of the deficiency.

Upon the filing of a declaration of taking, the court shall have power to fix the time within

which and the terms upon which the parties in possession shall be required to surrender possession to the petitioner. The court shall have power to make such orders in respect of encumbrances, liens, rents, taxes, assessments, insurance, and other charges, if any, as shall be just and equitable.

* * * * *

[40 U.S.C. 258a.]

Capehart Housing Amendments of 1955, c. 783, 69 Stat. 635:

Sec. 404 [as amended by Sec. 512, Housing Act of 1956, c. 1029, 70 Stat. 1091, 1111]. * * *

* * * * *

(c) Condemnation proceedings instituted pursuant to this section shall be conducted in accordance with the provisions of the Act of August 1, 1888 (25 Stat. 357; 40 U.S.C., sec. 257) as amended, or any other applicable Federal statute. Before any such condemnation proceedings are instituted, an effort shall be made to acquire the property involved by negotiation. In any condemnation proceedings instituted pursuant to this section, the court shall not order the party in possession to surrender possession in advance of final judgment unless a declaration of taking has been filed, and a deposit of the amount estimated to be just compensation has been made, under the first section of the Act of February 26, 1931 (46 Stat. 1421), providing for such declarations. Unless title is in dispute, the court, upon application, shall promptly pay to the owner at least 75 per centum of the amount so deposited, but such payment shall be made without prejudice to any party to the proceeding. In the event that condemnation proceedings are instituted in accordance with procedures under such Act of February 26, 1931, the court shall order that the amount deposited shall be paid in a lump

sum or over a period not exceeding five years in accordance with stipulations executed by the parties in the proceedings. In connection with condemnation proceedings which do not utilize the procedures under such Act, the Secretary or his designee, after final judgment of the court, may pay or agree to pay in a lump sum or, in accordance with stipulations executed by the parties to the proceedings, over a period not exceeding five years the difference between the outstanding principal obligation, plus accrued interest, and the price for the property fixed by the court. Unless such payment is made in a lump sum, the unpaid balance thereof shall bear interest at the rate of 4 per centum per annum.

* * * * *

[42 U.S.C. 1594a.]

Treasury Regulations on Income Tax (1954 Code):

§ 1.482–1 *Allocation of income and deductions among taxpayers.*

* * * * *

(b) *Scope and purpose.* (1) * * *

(2) Section 482 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

* * * * *

[26 C.F.R. 1.482–1.]

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§ 1.1502–80 *Applicability of other provisions of law.*

The Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application. Thus, for example, in a transaction to which section 381(a) applies, the acquiring corporation will succeed to the tax attributes described in section 381(c). Furthermore, sections 269, 304, and 482 apply for any consolidated return year.

[26 C.F.R. 1.1502–80.]

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